1983

Audits of employee benefit plans (1983); Audit and accounting guide:

American Institute of Certified Public Accountants. Employee Benefit Plans and ERISA Special Committee

AICPA

American Institute of Certified Public Accountants

AUDIT AND ACCOUNTING GUIDE

AUDITS OF EMPLOYEE BENEFIT PLANS

PREPARED BY THE
EMPLOYEE BENEFIT PLANS
AND ERISA SPECIAL COMMITTEE

NOTICE TO READERS

This audit and accounting guide presents recommendations of the AICPA Employee Benefit Plans and ERISA Special Committee regarding the application of generally accepted auditing standards to audits of financial statements of employee benefit plans, including defined benefit pension plans, defined contribution plans, and employee health and welfare benefit plans. The guide represents the considered opinion of the committee on the best auditing practice for employee benefit plans and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this guide if their work is challenged.

The Financial Accounting Standards Board has established generally accepted accounting principles for defined benefit pension plans. The appendixes to this guide reproduce parts of FASB Statement no. 35, *Accounting and Reporting by Defined Benefit Pension Plans*. This guide also includes descriptions of, and recommendations on, specialized accounting and reporting principles and practices for defined contribution plans and employee health and welfare benefit plans. The descriptions and recommendations may refer to an FASB statement or interpretation, an Accounting Principles Board opinion, or an accounting research bulletin, all of which are pronouncements enforceable under rule 203 of the AICPA Code of Professional Ethics. Although the guide does not have the authority of those pronouncements, it is intended to be helpful in determining whether financial statements are in conformity with generally accepted accounting principles. Statement on Auditing Standards No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, identifies AICPA guides as sources of established accounting principles that an AICPA member should consider.

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EMPLOYEE BENEFIT PLANS
AND ERISA SPECIAL COMMITTEE

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Preface

This guide has been prepared to assist the independent auditor in auditing and reporting on financial statements of employee benefit plans, including defined benefit pension plans, defined contribution plans, and employee health and welfare benefit plans. This guide applies to examinations of financial statements of employee benefit plans that are subject to the financial reporting requirements of the Employee Retirement Income Security Act of 1974, as well as those that are not.

This guide supersedes the 1972 AICPA Industry Audit Guide, *Audits of Employee Health and Welfare Benefit Funds*.

Generally accepted auditing standards and accounting principles are applicable in general to employee benefit plans. The broad application of those standards and principles is not discussed here. Rather, the guide focuses on the special problems in auditing and reporting on financial statements of employee benefit plans.

The guide contains certain suggested auditing procedures, but detailed internal accounting control questionnaires and audit programs are not included. The nature, timing, and extent of auditing procedures are a matter of professional judgment and will vary depending on the size, organizational structure, existing system of internal accounting control, and other factors in a specific engagement.

The guide also includes information regarding statutory rules and regulations applicable to employee benefit plans and illustrations of plan financial statements and auditors' reports.

The guidance in this audit guide is in certain respects more detailed than that generally included in other AICPA audit guides. To facilitate reference, paragraphs have been numbered and a topical index is provided.

Generally Accepted Accounting Principles

Audits of Employee Health and Welfare Benefit Funds described generally accepted accounting principles for health and welfare benefit funds. In March 1980 the Financial Accounting Standards Board issued Statement no. 35, *Accounting and Reporting by Defined Benefit Pension Plans*. FASB Statement no. 35 does not, however, apply to defined contribution plans and employee health and welfare benefit plans.

Chapters 3 and 4 of this guide describe the specialized accounting principles and practices for defined contribution plans and employee health and welfare benefit plans. The accounting guidance in those chapters is consistent with the accounting and reporting standards in FASB Statement no. 35 to the extent that this is appropriate.

Effective Date and Transition

The provisions of this guide are effective for examinations of financial statements for plan years beginning after December 31, 1982. Earlier application is encouraged.

Accounting changes adopted to conform to the principles and practices described in chapters 3 and 4 should be made retroactively. Financial statements of prior plan years should be restated to conform to the guide only if presented together with financial statements for plan years beginning after December 31, 1982. If accounting changes are necessary to conform to this guide, that fact should be disclosed when financial statements for the year in which this guide is first applied are presented either alone or only with financial statements of prior plan years.

Acknowledgments

The committee wishes to acknowledge the contributions of Charles W. Gill, Samuel T. Hicks, and Vincent C. Hennessy in the initial drafting of this audit guide.

The committee also expresses its appreciation to the members of the original Pension Funds Committee who began this project, and in particular, James I. Konkel, who was chairman of the committee from 1976 to 1979.

The committee also gives its special thanks to Walter C. Meck, to David A. Winetroub, and to former AICPA staff member David V. Roscetti for their work in preparing this guide and to Brian Zell of the AICPA Auditing Standards Division for guiding this project to its conclusion.

Employee Benefit Plans and
ERISA Special Committee

February 1983

Chapter 1

Introduction and Background

1.1. The purpose of this guide is to provide guidance to the independent auditor in examining and reporting on the financial statements of employee benefit plans (plans). This guide covers defined benefit pension plans, defined contribution plans, and health and welfare benefit plans.

1.2. *Defined benefit pension plans* provide a promise to pay participants benefits that are determinable, based on such factors as age, years of service, and compensation.

1.3. *Defined contribution plans* require an individual account for each participant and provide benefits that are based on (*a*) amounts contributed to the participant's account by the employer or employee, (*b*) investment experience on such amounts, and (*c*) any forfeitures allocated to the account. These plans include—

a. Profit-sharing plans, which provide for required or discretionary employer contributions from current or accumulated profits as specified by the plan.

b. Money-purchase pension plans, which base employer contributions on criteria other than profits, for example, compensation, units produced, length of service, or hours worked.

c. Stock-bonus and employee stock-ownership plans (ESOPs and TRASOPs), which use contributions primarily to purchase stock of the employer company. Employer contributions need not depend on the company's profits.

d. Thrift or savings plans, which provide for periodic employee contributions matched in whole or in part by the employer.

1.4. *Health and welfare benefit plans* include plans that provide—

a. Medical, dental, visual, or psychiatric care; life insurance; or accidental death or dismemberment benefits.
b. Benefits during periods of unemployment or disability.
c. Benefits during vacations or holidays.
d. Benefits such as apprenticeships, scholarships, day-care centers, or legal services.

1.5. This guide applies to the examination of financial statements of employee benefit plans that are subject to the financial reporting requirements of the Employee Retirement Income Security Act of 1974 (ERISA), as well as to those that are not. The guide discusses accounting, auditing, and reporting for ongoing employee benefit plans. A plan is the reporting entity under ERISA and Financial Accounting Standards Board (FASB) Statement no. 35, *Accounting and Reporting by Defined Benefit Pension Plans.* Although it does not specifically discuss accounting, auditing, and reporting for trusts as separate entities, this guide may be useful to auditors reporting on employee benefit trusts (see paragraph 12.18).

1.6. The guidance presented is not all-inclusive but, rather, is limited generally to matters that warrant special emphasis or when experience indicates that guidance may be useful. The independent auditor using this guide is expected to have knowledge of applicable financial accounting standards, auditing standards, and governmental regulations.

Financial Accounting and Reporting Standards

1.7. Employee benefit plans have become increasingly significant in our society. Until recently, however, financial accounting and reporting practices of employee benefit plans were quite varied.

1.8. FASB Statement no. 35, issued in March 1980, established standards of financial accounting and reporting for annual financial statements of defined benefit pension plans but did not establish standards for other types of employee benefit plans.

1.9. In 1972 the AICPA issued an Industry Audit Guide, *Audits* *of Employee Health and Welfare Benefit Funds*, which provided guidance on certain accounting, auditing, and reporting matters considered unique to such funds. This guide supersedes the 1972 guide and brings the recommended financial accounting and reporting standards for defined contribution plans (chapter 3) and employee health and welfare benefit plans (chapter 4) into conformity with those of other employee benefit plans to the extent that this is appropriate.

1.10. Employee benefit plans subject to ERISA are required to report certain information annually to government agencies and to provide summarized information to plan participants. For many plans, the reports include financial statements prepared in conformity with generally accepted accounting principles.

Governmental Regulations

1.11. Various provisions of the Internal Revenue Code cover employee benefit plans and trusts established pursuant to employee benefit plans. When an employee benefit plan and its underlying trust qualify under the code, certain tax benefits are available, including—

a. Current tax deductions by plan sponsors for contributions, subject to certain limitations.

b. Deferment of income to participants until the benefits are distributed or otherwise made available.

c. Exemption of the trust from income taxes, other than tax on unrelated business profits.

d. Favorable tax treatment of certain benefit distributions to participants or their estates.

1.12. ERISA vastly expanded government involvement in the operating and reporting practices of employee benefit plans. In addition to establishing extensive reporting requirements for covered plans, ERISA established minimum standards for participation, vesting, and funding for plans of private enterprises. It also established standards of fiduciary conduct and imposed specific restrictions and responsibilities on fiduciaries.

1.13. Under ERISA the Department of Labor (DOL) and the Internal Revenue Service have the authority to issue regulations covering reporting and disclosure requirements, certain administrative responsibilities, and enforcement powers. The Pension Benefit Guaranty Corporation (PBGC) guarantees participants in defined benefit pension plans against the loss of certain pension benefits if the plan terminates, and it administers terminated plans in certain circumstances.

1.14. The auditing procedures in this guide are designed for examinations in accordance with generally accepted auditing standards. DOL regulations, however, permit a plan administrator to limit the scope of an auditor's examination with regard to any statement or information prepared and certified by a bank or similar institution or by an insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency. This guide applies to these limited-scope examinations except as it relates to auditing procedures described in chapter 7 regarding information on investments certified by a bank or similar institution or by an insurance carrier. Procedures regarding that information will be limited to comparing the information certified by the bank or the insurance carrier to the information included in the plan's financial statements. Guidance on the auditor's report and responsibilities for this type of limited-scope examination is provided in paragraphs 12.14 through 12.16.

1.15. Appendix A describes pertinent provisions of ERISA and related reporting and disclosure regulations issued by the DOL. Additional guidance concerning the effects of the Internal Revenue Code, ERISA, and related regulations on the operating and reporting practices of employee benefit plans is given elsewhere in this guide.

Operating and Administrative Characteristics of Employee Benefit Plans

1.16. Employee benefit plans are diverse. They vary not only by basic type (defined benefit pension plans, defined contribution plans, and health and welfare benefit plans) but in basic operating and administrative characteristics. The IRS has prepared standard (master or prototype) plans. In addition, model or pattern plans that have IRS approval are available from various sources.

1.17. A plan sponsor may establish a plan unilaterally (conventional or voluntary plan) or as a result of collective bargaining (negotiated plan).

1.18. An employee benefit plan may be a single-employer plan or a multiemployer plan.[1] The most distinguishing characteristic between multiemployer plans and single-employer plans is their administration. Multiemployer plans are normally negotiated and established pursuant to a collective bargaining agreement between an associated group of employers, such as in the construction trades, and the union representing the employees. The plan sponsor of a multiemployer plan, with whom ultimate responsibility rests, is a joint employer/union board of trustees. By contrast, single-employer plans are established by the management of one employer, either unilaterally or through collective bargaining. In a single-employer plan, the employer is the plan sponsor.

1.19. Contributions may be required from both employers and participants (contributory plans) or from employers only (noncontributory plans). A noncontributory plan may contain a provision for payment of contributions or premiums by participants to maintain their eligibility during periods of unemployment; they may also provide for voluntary contributions by participants.

1.20. Assets necessary to provide benefits are derived from a fund of accumulated contributions and income (self-insured plan), are funded through insurance contracts (insured plan), or are funded through a combination of both (split-funded plan).

Operation and Administration

1.21. An employee benefit plan is normally established and maintained by a plan sponsor pursuant to a plan instrument. The provisions of a plan instrument normally deal with such matters as eligibility to participate, entitlement to benefits, funding, plan amendments, operation and administration of plan provisions, allocation of responsibilities among specified fiduciaries for control and management of the plan, and delegation by fiduciaries of duties

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1. ERISA defines the term "multiemployer plan" as a plan to which more than one employer is required to contribute, which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer, and which satisfies other requirements that may be prescribed by DOL regulations. As used in this guide, the term "single-employer plan" may include plans with more than one employer under common control.

in connection with administration of the plan. A plan subject to ERISA is required to be in writing.

1.22. Named fiduciaries control and manage the operation and administration of a plan. They have continuing responsibility for operation of the plan in accordance with the terms of the plan instrument, any trust instrument or insurance contracts, and governmental regulations. Generally, they make policy decisions concerning such matters as interpretation of the plan, determination of the rights of participants under the plan, management of investments, and delegation of operational and administrative duties.

1.23. Named fiduciaries usually are officers or other employees of the plan sponsor, and they typically report to the plan sponsor's board of directors or management. Sometimes trustees are union representatives.

1.24. Although named fiduciaries retain responsibility for the overall direction of the plan, the plan's day-to-day administration (for example, collection of contributions, payment of benefits, management of cash and investments, maintenance of records, and preparation of reports) generally is allocated to one or more of the following:

a. The plan sponsor
b. A trustee, such as a bank trust department
c. An insurance company
d. An investment adviser
e. The person or persons designated as the plan administrator or administrative agent

1.25. In a self-insured plan the assets typically are managed in accordance with a trust instrument that sets forth, among other matters, the authority and responsibilities of the trustee and any investment adviser. In an insured plan the assets typically are managed in accordance with an agreement that sets forth the duties and responsibilities of the insurance carrier.

Accounting Records

1.26. As with any other entity, the records of an employee benefit plan should produce information necessary for effective management and reliable financial reporting. The complexity of a plan's accounting records will vary with such factors as the type of plan, number of employer contributors, complexity of the benefit formula, variety of benefit payment options, and delegation of administrative duties.

1.27. The accounting records for employee benefit plans typically are maintained at a number of locations. Depending on the type of plan, the allocation of fiduciary responsibilities, and the delegation of administrative duties under the plan, records may be maintained by trustees, insurance companies, consulting actuaries, service bureaus, the plan administrator, and plan sponsors. The records of a plan generally should include—

a. *Investment asset records.* ERISA requires detailed reporting of investment assets and such related transactions as schedules of reportable transactions, party-in-interest transactions, and leases and loans in default. The disclosure provisions of ERISA and related regulations often necessitate records for employee benefit plans that are more detailed and extensive than those for other entities.

b. *Participants' records.* Adequate records should be maintained to determine each employee's eligibility to participate in the plan and receive benefits. Eligibility for participation and benefits may be based on such factors as periods of service, earnings, production, and contributions, and can be affected by age or breaks in service. These records are generally part of or derived from the personnel and payroll records maintained by the employer or the plan, and these records are used by the plan's actuary.

c. *Contribution records.* Separate contribution records must be maintained for each plan contributor to record payments and accumulated contributions and to determine delinquencies and errors. These records should be detailed enough to record contributions and payments received from a number of employers according to pertinent agreements or from individual participants.

d. *Claim records.* For health and welfare plans claim records are significant. They are used for such purposes as determining when benefit limits, if any, are reached by individual claimants and accumulating various historical data regarding types and amounts of claims, amounts paid, and timing of claims.

e. Distribution records. Records should be maintained to support all distributions. These records should identify entitlements, amounts, commencement data, terminations, forfeitures, transfers, and information to determine the tax consequences of distributions.

f. Separate participants' accounts. Defined contribution plans require, as additional records, separate accounts reflecting each plan participant's share of the total net assets of the plan. Changes in the value of net assets are allocated to the participants' accounts in accordance with the plan instrument.

Chapter 2

Accounting and Reporting by Defined Benefit Pension Plans

2.1. FASB Statement no. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* establishes generally accepted accounting principles for defined benefit pension plans and prescribes the general form and content of financial statements of those plans. FASB Statement no. 35 establishes standards only for defined benefit pension plans, including private sector plans and state and local government plans.[1]

2.2. The FASB has determined that the primary objective of a plan's financial statements is to provide information that is useful in assessing the plan's present and future ability to pay benefits when they are due. That objective requires the presentation of information about the plan's economic resources and a measure of participants' accumulated benefits.

2.3. This chapter is intended to familiarize the auditor with some of the principal provisions of FASB Statement no. 35. Additionally, further discussion of certain principles set forth in the statement is provided for the guidance of the auditor in making his examination. This chapter is not intended to serve as a substitute for the statement. Appendix C of this guide reproduces the accounting standards of FASB Statement no. 35. Also, Appendix D contains the glossary, and Appendix E contains the illustrative financial statements from the statement.

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1. FASB Statement no. 59 amended Statement no. 35 to defer its effective date for state and local government plans to years beginning after June 15, 1982.

Financial Statements

2.4. The financial statements of a defined benefit pension plan should be prepared on the accrual basis and should include—

a. A statement of the net assets available for benefits as of the end of the plan year.

b. A statement of changes in net assets available for benefits for the year then ended.

c. Information regarding the actuarial present value of accumulated plan benefits.

d. Information regarding the effects, if significant, of certain factors affecting the year-to-year change in accumulated plan benefits.

2.5. FASB Statement no. 35 gives guidance on the form and content of the required financial statements and specifies that they be presented in sufficient detail to assist readers of plan financial statements in assessing the plan's present and future ability to pay benefits when due. Information regarding the actuarial present value of accumulated plan benefits and changes therein, however, may be presented in the financial statements or in the notes.

Net Assets Available for Plan Benefits

2.6. Except for contracts with insurance companies, plan investments are to be presented at their fair value at the reporting date. Fair value of plan investments is the amount that the plan could reasonably expect to receive in a current sale of assets and should be measured by quoted market prices when available. Original cost of investments is not required to be disclosed. Assets used in the administration of the plan are to be stated at cost less accumulated depreciation.

2.7. Some plan investments may not have market quotations and, therefore, will need to be valued "in good faith." Examples include real estate, mortgages or other loans, restricted securities, unregistered securities, and securities for which the market is thin. It is the obligation of the plan's trustees, the administrator, and the corporate trustee *(a)* to satisfy themselves that all appropriate factors relevant to the value of the investments have been considered and *(b)* to select a method to estimate the fair value of the investments. To the extent considered necessary, the plan may use the services of a specialist to estimate the fair value of investments valued in good faith.

2.8. Some of the general factors that may be considered in estimating the fair value of plan investments are the type of investment, cost at date of purchase, size and period of holdings, information about transactions or offers regarding the investment, reported prices and extent of trading in similar investments, a forecast of expected cash flows from the investment, changes in economic conditions relating to the investment, financial condition of the investee or issuer, and the nature and duration of restrictions on disposition. The foregoing is not a complete list of all factors that may be considered.

2.9. Whether or not the plan is subject to ERISA, contracts with insurance companies are to be included as plan assets in the manner required by ERISA and are to be reported in a manner consistent with item 13 of either Form 5500 or 5500-C of the DOL. Accordingly, those contracts under which payments to the insurance company are "allocated" specifically to individual participants would be excluded from plan assets. Under such an arrangement the sponsor, on payment of a premium, has effectively transferred all future risk to the insurance company. Those contracts that are "unallocated" in nature should be included in the statement of assets at their contract value as defined by ERISA and required by item 13 of Form 5500 or 5500-C. Further discussion of insurance contracts is provided in chapter 7.

2.10. Presentation of plan investments in the statement of net assets should be detailed by general type, such as government securities, short-term securities, corporate bonds, common stocks, mortgages, and real estate. Also reflected as individual line items in the financial statements are investments in bank common and commingled trust funds and master trusts and investments in contracts with insurance companies, including separate accounts, deposit administration (DA), and immediate participation guarantee (IPG) contracts. The presentation should also indicate whether the fair values of the investments have been measured by quoted market prices in an active market or were otherwise determined.

2.11. Contributions receivable are amounts due as of the date of the financial statements, including legal or contractual obligations as well as obligations resulting from a formal commitment. Evidence of a formal commitment may include *(a)* a formal resolution by the sponsor, *(b)* amounts relating to an established funding policy, *(c)* a deduction on the federal tax return, or *(d)* the employer's recognition, as of the reporting date, of a contribution payable to the plan. Contributions receivable should include an allowance for estimated uncollectible amounts.

2.12. A plan may have liabilities that should be accrued for amounts owed for securities purchased or for expenses. These would be deducted in arriving at net assets available for plan benefits. Accumulated plan benefits are not appropriate deductions in arriving at net assets available for plan benefits.

Changes in Net Assets Available for Plan Benefits

2.13. The statement of changes in net assets available for plan benefits is intended to present the effects of significant changes in net assets during the year and should present, at a minimum—

a. The net change in the fair value (or estimated fair value) of each significant type of investment (see paragraph 2.10). Gains and losses from investments sold need not be segregated from unrealized gains and losses relating to investments held at year-end.

b. Investment income, exclusive of changes in fair value described in *(a)* above.

c. Contributions from employers.

d. Contributions from participants.

e. Contributions from other sources.

f. Benefits paid.

g. Payments to insurance companies to purchase contracts that are excluded from plan assets.

h. Administrative expenses.

Other changes, for example transfers of assets to or from other plans, should also be presented if they are significant.

Accumulated Plan Benefits

2.14. Accumulated plan benefits are to be presented as the present value of future benefits attributable, under the plan's provisions, to service rendered to the date of the actuarial valuation. The accumulated benefit information may be presented as of the beginning or the end of the plan year; under FASB Statement no. 35, however, an end-of-year benefit information date is considered preferable. If the information is as of the beginning of the year, prior-year statements of net assets and changes therein are also required; otherwise comparative statements are not required.

2.15. Accumulated plan benefits include benefits for *(a)* retired or terminated employees or their beneficiaries, *(b)* beneficiaries of deceased employees, and *(c)* present employees or their beneficiaries. To the extent possible, plan provisions should govern the measurement of accumulated plan benefits. When the plan does not specify the benefit earned in each year, a general method for measurement is provided in FASB Statement no. 35, paragraph 17. Future service should be considered only in determining an employee's expected eligibility for certain benefits. Future increases in salaries and benefits are assumed only to the extent that they have been specified, for example, automatic cost-of-living increases. Plans providing death or disability benefits should consider these factors in the calculation. Plan amendments occuring after the date of the calculation should be excluded. As in the presentation of plan assets, benefits that are guaranteed by a contract with an insurance company, that is, "allocated contracts," should be excluded.

2.16. The assumptions used in calculating accumulated plan benefits are to be based on the premise of an ongoing plan. Accordingly, the interest rates used for discounting expected future payments should reflect the rates of return expected on plan investments during the periods for which the benefits are deferred. An appropriate allowance for future employee mortality and turnover should be provided. The significant assumptions used in the calculation must be developed using an "explicit" approach, whereby each assumption, standing alone, represents the best estimate of the plan's future experience. These assumptions may differ from those used in the determination of the plan's funding and the plan sponsor's pension costs.

2.17. As noted previously, the benefit information may be presented in a separate statement, combined with other information in a financial statement, or presented in a note to the financial statements. The information, however, must all be located in one place and should be classified as follows:

a. Vested benefits of participants currently receiving benefits

b. Other vested benefits

c. Nonvested benefits

If the plan is contributory, accumulated contributions of active employees including, if applicable, interest credited on those contributions, should be disclosed. If interest is credited on the contributions, the interest rate should also be disclosed.

Changes in Accumulated Plan Benefits

2.18. Information regarding the change in accumulated benefits from the beginning to the end of the year should be presented to identify significant factors affecting the comparability of the year-to-year accumulated benefits. As with the accumulated benefit information, the changes may be presented in the body of the financial statements or in the notes; they may be presented in either a reconciliation or a narrative format. Minimum disclosures should include the significant effects of such factors as plan amendments, changes in the nature of the plan, and changes in actuarial assumptions. Changes in actuarial assumptions are to be viewed as changes in accounting estimates, and, therefore, previously reported amounts should not be restated. If only the minimum required disclosure is presented, presentation in a statement format will necessitate an additional unidentified "other" category to reconcile the beginning and ending amounts.

Additional Financial Statement Disclosures

2.19. The significant accounting policies of the plan should be disclosed. APB Opinion no. 22 provides guidance on the disclosure of accounting policies, and FASB Statement no. 35 requires disclosure of *(a)* the method and significant assumptions used to value investments and contracts with insurance companies and *(b)* the method and significant assumptions used in determining the actuarial present value of accumulated plan benefits, including any significant changes in the method or assumptions during the year.

2.20. FASB Statement no. 35 also requires disclosure of—

a. A brief general description of the plan agreement, including its vesting and benefit provisions.

b. A description of significant plan amendments adopted during the year. If the amendments were adopted after the date of the accumulated benefit information, and accordingly their effect was not included in the calculation, this fact should be stated.

c. A brief description of the benefit priority and PBGC coverage in the event of plan termination.

d. The funding policy and any changes in the policy during the year. When applicable, the method of determining employee contributions should be disclosed. ERISA plans should disclose their status with respect to minimum funding requirements.

e. The policy regarding the purchase of insurance contracts that have been excluded from plan assets and the income from those contracts for the year.

f. The federal income tax status of the plan if a favorable determination letter from the IRS has not been obtained or maintained.

g. Investments exceeding 5 percent of total net assets.

h. Significant related-party transactions.

i. Significant subsequent events that may affect the usefulness of the financial statements.

2.21. The summary in this chapter is not intended to modify the requirements of FASB Statement no. 35 but, rather, to serve as a reference to the major provisions of the statement. Appendixes C, D, and E of this guide, as well as the entire statement issued by the FASB, should be referred to for the specific accounting requirements for defined benefit pension plans.

Chapter 3

Accounting and Reporting by Defined Contribution Plans

3.1. Defined contribution pension plans provide for individual accounts for each participant representing benefits based on (*a*) amounts contributed to the participants' accounts by the employer or employee, (*b*) investment experience on those amounts, and sometimes (*c*) forfeitures allocated to the account.

3.2. Under a defined contribution plan the contribution rate is generally determined by the participant's compensation, profits of the employer, or both. In some plans, the contribution may be determined periodically at the discretion of the employer. When a participant retires or withdraws from the plan, the amount allocated to the participant's account (if he is fully vested) represents his accumulated benefit, and it may be paid to the participant or used to purchase a retirement annuity. The amount of benefits a participant will ultimately receive is generally not determined until the time of payment. By contrast, in a defined benefit pension plan, benefits are determinable, and the contribution necessary to provide those benefits is actuarially calculated. In other respects defined contribution plans are similar to defined benefit plans.

3.3. The basic types of defined contribution plans are—

a. Profit-sharing plans, which provide for required or discretionary employer contributions from current or accumulated profits as specified by the plan.

b. Money-purchase pension plans, which base employer contributions on criteria other than profits, for example, on compensation, units produced, length of service, or hours worked.

c. Stock bonus plans, employee stock-ownership plans (ESOPs), and tax reform act stock-ownership plans (TRASOPs), which use contributions primarily to purchase stock of the employer company. Employer contributions need not depend on the company's profits.

d. Thrift or savings plans, which provide for periodic employee contributions matched in whole or in part by contributions by the employer.

Regulatory Reporting Requirements

3.4. ERISA established annual reporting requirements for employee benefit plans, including defined contribution plans. Those requirements are described in Appendix A of this guide. The financial statements ERISA requires for pension plans are a statement of assets and liabilities and a statement of changes in net assets available for plan benefits.

3.5. Some defined contribution plans, such as certain employee stock-purchase, savings, and similar plans, are required to register and report to the Securities and Exchange Commission. Regulation S-X prescribes the form of the statements of financial condition and statements of income and changes in plan equity that those plans must file with the SEC.

3.6. The Internal Revenue Service requires that accumulated benefits under defined contribution plans be calculated at least annually. In addition, proposed DOL regulations require that each participant have the right to receive a statement of his vested and nonvested accrued benefits at least annually.

3.7. FASB Statement no. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, issued in March 1980, applies only to defined benefit pension plans. As noted in paragraph 3.2, however, except for differences in determining plan benefits, defined contribution plans are similar to defined benefit plans, and the guidance in this chapter is consistent with the accounting and reporting standards in FASB Statement no. 35 to the extent that this is appropriate.

Scope

3.8. This chapter describes generally accepted accounting principles for financial reporting by defined contribution plans. Existing generally accepted accounting principles other than those discussed in this chapter may also apply. The principles described are particularly important to defined contribution plans or are different from existing generally accepted accounting principles for other types of entities.

Financial Statements

3.9. The primary objective of a defined contribution plan's financial statements is to provide information about (*a*) plan resources and how the stewardship responsibility for those resources has been discharged, (*b*) the results of transactions and events that affect the information about those resources, and (*c*) other factors necessary for users to understand the information provided.[1]

3.10. The financial statements of a defined contribution plan should include—

a. A statement that includes information regarding net assets available for benefits of the plan as of the financial statement date.

b. A statement that includes information regarding the changes during the period in net assets available for benefits of the plan.

Appendix F provides illustrative financial statements for a defined contribution plan.

3.11. The accrual basis of accounting should be used in preparing information regarding net assets available for plan benefits and related changes.[2] The information should be presented in such reasonable detail as necessary to identify the plan's net assets available for benefits and related changes.

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1. It should be recognized that (*a*) information in addition to that contained in a plan's financial statements is needed in assessing the plan's present and future ability to pay benefits when due and (*b*) financial statements for several plan years can provide more useful information for assessing the plan's future ability to pay benefits than can financial statements for a single plan year.

2. The accrual basis requires that purchases and sales of securities be recorded on a trade-date basis. If the settlement date is after the financial statement date, however, and (*a*) the fair value of the securities purchased or sold just before the financial statement date does not change significantly from the trade date to the financial statement date and (*b*) the purchases or sales do not significantly affect the composition of the plan's assets available for benefits, accounting on a settlement-date basis for such sales and purchases is acceptable.

Net Assets Available for Plan Benefits

Investments

3.12. Plan investments, whether equity or debt securities, real estate, or other investments (excluding contracts with insurance companies), should be presented at their fair value at the financial statement date. The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value should be measured by the market price if there is an active market for the investment. If there is no active market for an investment but there is a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows may aid in estimating fair value, provided the expected cash flows are discounted at a rate commensurate with the risk involved.[3]

3.13. Contracts with insurance companies should be presented in the same manner as that contained in the annual report filed by the plan with certain governmental agencies pursuant to ERISA.[4] A plan not subject to ERISA should present its contracts with insurance companies as if the plan were subject to the reporting requirements of ERISA.

3.14. Information regarding a plan's investments should be presented in enough detail to identify the types of investments and should indicate whether reported fair values have been measured by quoted prices in an active market or are fair values otherwise determined. Paragraph 3.20 specifies additional disclosures related to investments.

Contributions Receivable

3.15. Contributions receivable are the amounts due, as of the financial statement date, to the plan from employers, participants,

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3. For an indication of the factors to be considered in determining the discount rate, see paragraphs 13 and 14 of APB Opinion no. 21, *Interest on Receivables and Payables.* If significant, the fair value of an investment should reflect the brokerage commissions and other costs normally incurred in a sale. (See also paragraphs 2.7 and 2.8 of this guide.)
4. For 1981 plan years the pertinent governmental reporting requirements relate to item 13 of either Form 5500 or Form 5500-C.

and other sources of funding (for example, state subsidies or federal grants, which should be separately identified). Amounts due include those pursuant to formal commitments as well as legal or contractual requirements. With respect to an employer's contributions, evidence of a formal commitment may include (*a*) a resolution by the employer's governing body approving a specified contribution, (*b*) a consistent pattern of making payments after the plan's year-end pursuant to an established contribution policy that attributes such subsequent payments to the preceding plan year, (*c*) a deduction of a contribution for federal tax purposes for periods ending on or before the financial statement date, or (*d*) the employer's recognition as of the financial statement date of a contribution payable to the plan.[5]

Operating Assets

3.16. Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) should be presented at cost less accumulated depreciation or amortization.

Changes in Net Assets Available for Plan Benefits

3.17. Information regarding changes in net assets available for plan benefits should be presented in enough detail to identify the significant changes during the period. The minimum disclosures should include—

a. The net appreciation or depreciation in fair value for each significant class of investments, segregated between investments whose fair values have been measured by quoted prices in an active market and those whose fair values have been otherwise determined.[6]

b. Investment income, excluding (*a*) above.

c. Contributions from employers, segregated between cash and noncash contributions. (A noncash contribution should be re-

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5. The existence of an accrued contribution payable in the employer's financial statements does not, by itself, provide sufficient support for recognition of a contribution receivable by the plan.

6. Realized gains and losses on investments that were both bought and sold during the period should be included.

corded at fair value. The nature of noncash contributions should be described either parenthetically or in a note.)

d. Contributions from participants, including those transmitted by the sponsor.

e. Contributions from other identified sources (for example, state subsidies or federal grants).

f. Benefits paid to participants.

g. Payments to insurance companies to purchase contracts that are excluded from plan assets.

h. Administrative expenses.

3.18. The minimum disclosures should be made to the extent they apply to the plan. The list of minimum disclosures is not intended to limit the amount of detail or the manner of presenting the information, and subclassifications or additional classifications may be useful.

Additional Financial Statement Disclosures

3.19. Disclosure of the plan's accounting policies should include a description of the methods and significant assumptions used to determine the fair value of investments and the reported value of contracts with insurance companies (if any).[7]

3.20. The financial statements should also disclose, if applicable—

a. A brief, general description of the plan agreement including, but not limited to, vesting and allocation provisions and the disposition of forfeitures. If a plan agreement or a description providing this information is otherwise published and made available, this description may be omitted from the financial statements provided that reference to the other source is made.

b. The amount of unallocated assets, as well as the basis used to allocate asset values to participants' accounts when that basis differs from the one used to record assets in the financial statements.

c. The basis for determining contributions by employers and, for a contributory plan, the method of determining participants'

7. See APB Opinion no. 22, *Disclosure of Accounting Policies*.

contributions.[8] Plans subject to the minimum funding requirements of ERISA, such as certain money-purchase plans, should disclose whether those requirements have been met. If a minimum funding waiver has been granted by the IRS, or if a request for a waiver is pending before the IRS, that fact should be disclosed.

d. The policy regarding the purchase of contracts with insurance companies that are excluded from plan assets.

e. A description of significant plan amendments adopted during the period, and the effects of such amendments on net assets if significant either individually or in the aggregate.

f. The federal income tax status of the plan if a favorable letter of determination has not been obtained or maintained.

g. Identification of investments that represent 5 percent or more of the net assets available for benefits.

h. Significant real estate or other transactions in which the plan and any of the following parties are jointly involved: the sponsor, the plan administrator, employers, or employee organizations.

i. Investments pledged to secure debt of the plan as well as a description of the provisions regarding the release of such investments from the pledge and the amounts of investments released from the pledge in the last period.

j. Guarantees by others of debt of the plan.

k. The amount of net assets at the end of the period and changes in net assets during the period allocated to separate funds if the plan provides for separate investment programs with separate funds and if the allocation of net assets and changes in net assets to the separate funds is not shown in the financial statements in columnar form or by separate financial statements for each fund. If the plan provides for self-directed investment programs for individual participants, amounts relating to those individual programs should be aggregated as a separate fund and shown either in the financial statements or in the related disclosures.

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8. If significant costs of plan administration are being absorbed by the employer, that fact should be disclosed.

l. For plans that assign units to participants, the total number of units and the net asset value per unit during the period (for example, monthly or quarterly, depending on the plan's provisions for calculating the unit values) and at the end of the period.

m. Amounts allocated to accounts of persons who have withdrawn from participation in the earnings and operations of the plan.

n. Unusual or infrequent events or transactions occurring after the financial statement date, but before issuance of the financial statements, that might significantly affect the usefulness of the financial statements. If reasonably determinable, the effects of such events or transactions should be disclosed. If such effects are not quantified, the reasons why they are not reasonably determinable should be disclosed.

Chapter 4

Accounting and Reporting by Employee Health and Welfare Benefit Plans

4.1. Employee health and welfare benefit plans include plans that provide—

a. Medical, dental, visual, or psychiatric care; life insurance; or accidental death or dismemberment benefits.

b. Benefits during periods of unemployment or disability.

c. Benefits during vacations or holidays.

d. Benefits such as apprenticeships, scholarships, day-care centers, or legal services.

4.2. The participants in health and welfare benefit plans may be employees of a single employer or of a group of employers. Contributions by an employer may be voluntary or may be required under the terms of a collective bargaining agreement negotiated with one or more labor organizations. Contributions may be required from employers and participants (contributory plans) or from employers only (noncontributory plans). A noncontributory plan may provide for self-payment of contributions by participants to maintain their eligibility for benefits during periods of unemployment. Benefits either are paid from a fund's accumulated contributions and income (a self-insured plan) or are provided through insurance with an insurance company (an insured plan). Health and welfare benefit plans generally are subject to the requirements of ERISA.

Background and Scope

4.3. The 1972 AICPA Industry Audit Guide, *Audits of Employee Health and Welfare Benefit Funds*, prepared by the AICPA Committee on Health, Welfare, and Pension Funds, described generally accepted accounting principles for health and welfare benefit funds.

4.4. FASB Statement no. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, does not apply to health and welfare benefit plans, but it establishes certain standards that differ from those in the 1972 audit guide, primarily relating to the valuation of plan investments and additional financial statement disclosures.

4.5. This chapter describes generally accepted accounting principles for financial statements of health and welfare benefit plans. This chapter replaces the accounting and reporting principles and practices specified in *Audits of Employee Health and Welfare Benefit Funds*.

4.6. Existing generally accepted accounting principles other than those discussed in this chapter may also apply. The principles described in this chapter are particularly important to health and welfare benefit plans or are different from existing generally accepted accounting principles for other types of entities.

Financial Statements

4.7. The primary objective of a health and welfare benefit plan's financial statements is to provide information about (*a*) plan resources and obligations and how the stewardship responsibility for those resources and obligations has been discharged, (*b*) the results of transactions and events that affect the information about those resources and obligations, and (*c*) other factors necessary for users to understand the information provided.[1]

4.8. The financial statements of a health and welfare benefit plan should include a statement of net assets of the plan, presenting assets and liabilities as of the end of the period, and a statement

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1. It should be recognized that (*a*) information in addition to that contained in the plan's financial statements is needed in assessing the plan's present and future ability to pay benefits when due and (*b*) financial statements for several plan years can provide more useful information in assessing the plan's future ability to pay benefits than can financial statements for a single plan year.

of changes in net assets during the period. The accrual basis of accounting should be used in preparing a plan's financial statements.[2] Appendix G provides illustrative financial statements of a health and welfare benefit plan and a vacation benefit plan.

Statement of Net Assets

Investments

4.9. Plan investments, whether equity or debt securities, real estate, or other investments (excluding contracts with insurance companies), should be presented at their fair value at the financial statement date. The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value should be measured by the market price if there is an active market for the investment. If there is no active market for an investment but there is a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows may aid in estimating fair value, provided the expected cash flows are discounted at a rate commensurate with the risk involved.[3]

4.10. Contracts with insurance companies should be presented in the same manner as that contained in the annual report filed by the plan with certain governmental agencies pursuant to ERISA.[4] A plan not subject to ERISA should present its contracts with insurance companies as if the plan were subject to the reporting requirements of ERISA.

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2. The accrual basis requires that purchases and sales of securities be recorded on a trade-date basis. If the settlement date is after the financial statement date, however, and (*a*) the fair value of the securities purchased or sold just before the financial statement date does not change significantly from the trade date to the financial statement date and (*b*) the purchases or sales do not significantly affect the composition of the plan's assets available for benefits, accounting on a settlement-date basis for such sales and purchases is acceptable.

3. For an indication of the factors to be considered in determining the discount rate, see paragraphs 13 and 14 of APB Opinion no. 21, *Interest on Receivables and Payables*. If significant, the fair value of an investment should reflect the brokerage commissions and other costs normally incurred in a sale. (See also paragraphs 2.7 and 2.8 of this guide.)

4. For 1981 plan years the pertinent governmental reporting requirements relate to item 13 of either Form 5500 or 5500-C.

4.11. Information regarding a plan's investments should be presented in enough detail to identify the types of investments and should indicate whether reported fair values have been measured by quoted prices in an active market or are fair values otherwise determined. Paragraphs 4.26*f* and 4.26*g* specify additional disclosures related to investments.

Contributions Receivable

4.12. Contributions receivable are the amounts due, as of the financial statement date, to the plan from employers, participants, and other sources of funding (for example, state subsidies or federal grants, which should be separately identified). Amounts due include those pursuant to formal commitments as well as legal or contractual requirements. With respect to an employer's contributions, evidence of a formal commitment may include (*a*) a resolution by the employer's governing body approving a specified contribution, (*b*) a consistent pattern of making payments after the plan's year-end pursuant to an established funding policy that attributes such subsequent payments to the preceding plan year, (*c*) a deduction of a contribution for federal tax purposes for periods ending on or before the financial statement date, or (*d*) the employer's recognition as of the financial statement date of a contribution payable to the plan.[5]

Operating Assets

4.13. Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) should be presented at cost less accumulated depreciation or amortization.

insurance Premiums Payable

4.14. Benefits to participants may be provided through insurance arrangements that transfer the risks of loss or liability to an insurance company. Group insurance contracts for health and welfare plans are usually written for a one-year period, although the contract may provide for annual renewal. The contract may specify, among other things, the schedule of benefits, eligibility rules, premium rate per eligible participant, and the date that premiums are

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5. The existence of accrued costs in the employer's financial statements or a deficit in net assets of the plan do not, by themselves, provide sufficient support for recognition of a contribution receivable by the plan.

due. The plan's financial statements should include a liability for premiums due but not paid.

4.15. If the insurance policy requires payment of additional contingent premiums when the loss ratio exceeds a specified percentage, a liability for the estimated additional premiums should be recorded.

Deposits with Insurance Companies

4.16. Whether a premium paid to an insurance company represents payment for the transfer of risk or whether it represents merely a deposit will depend on the circumstances of each insurance arrangement. An analysis of the contract is needed to determine whether risk has been transferred from the plan and to what extent. Many insurance companies require that a deposit be maintained that can be applied against possible future losses in excess of current premiums. Premium deposits should be reported as assets of the plan until they are refunded to the plan or it becomes probable that the insurance company will apply the deposit as payment of premiums. Disclosure of the nature of this type of deposit should be made in the financial statements.

Accrued Experience Rating Adjustments

4.17. Certain group insurance contracts covering health and welfare benefit plans include a provision for the refund, at the end of the policy year, of the excess of premiums paid over paid claims, reserves required by the insurance company, and the insurance company's retention (fee). Often such experience rating refunds (or dividends) are not determined by the insurance company for several months after the year-end. In this event, and in cases when the policy year does not coincide with the plan's fiscal year, the refund due as of the financial statement date should be recorded if the amount can be reasonably estimated. If the amount of the refund cannot be reasonably estimated, that fact should be disclosed.

4.18. Experience ratings, determined by the insurance company or by estimates, may also result in a premium deficit. Premium deficits should be recorded as a liability of the plan (or a reduction of a deposit, if applicable) if (*a*) it is probable that the deficit will be applied against the amounts of future premiums or experience rating refunds[6] and (*b*) the amount can be reasonably estimated. If no accrual is made for a premium deficit because one or both of the conditions are not met, or if an exposure to loss exists in excess of the amount accrued, disclosure of the premium deficit should be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.

Claims

4.19. In an insured health and welfare benefit plan, claims reported to the plan but not paid and claims incurred but not yet reported to the plan will be paid by the insurance company and, therefore, will not appear in the financial statements as liabilities of the plan. The financial statements of a self-insured plan should present the amount of each of those liabilities.

4.20. Claims reported but not paid may be determined from the records of the plan. The estimated liability for claims incurred but not reported is generally determined by a specialist, such as the plan's actuary.

4.21. If a self-insured plan provides death benefits, the financial statements should include the estimated liability for those benefits based on determinations by the plan's actuary.

Accumulated Eligibility Credits

4.22. The eligibility rules of some plans provide for the payment of insurance premiums or benefits for a period of time subsequent to the financial statement date for those participants who have accumulated a sufficient number of eligibility credits or hours. Such rules permit eligible participants insurance coverage or benefits during periods of unemployment, when employer contributions to the plan would otherwise not provide coverage or benefits. At the financial statement date, such accumulated eligibility credits represent a liability of the plan arising from prior employee service for which employer contributions have been received. The liability is generally determined by applying current insurance premium

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6. Considerations in making this determination include (*a*) the extent to which the contract with the insurance company requires payment of such deficits and (*b*) whether the plan intends to transfer coverage to another insurance company.

rates to accumulated eligibility credits or, for a self-insured plan, by applying the average cost of benefits per eligible participant.

Statement of Changes in Net Assets

4.23. The statement of changes in net assets during the period should be presented in enough detail to identify the significant changes during the period. The minimum disclosures should include—

a. The net appreciation or depreciation in fair value for each significant class of investments, segregated between investments whose fair values have been measured by quoted prices in an active market and those whose fair values have been otherwise determined.[7]

b. Investment income, excluding (*a*) above.

c. Contributions from employers, segregated between cash and noncash contributions. (A noncash contribution should be recorded at fair value. The nature of noncash contributions should be described either parenthetically or in a note.)

d. Contributions from participants, including those transmitted by the sponsor.

e. Contributions from other identified sources (for example, state subsidies or federal grants).

f. Benefits paid to participants. This should not include benefit payments made by an insurance company in accordance with a contract that is excluded from plan assets.

g. Payments of premiums to insurance companies.

h. Changes during the period in liabilities for benefits by major types.

i. Administrative expenses.

j. Change during the period in net assets.

4.24. The minimum disclosures should be made to the extent they apply to the plan. The list of minimum disclosures is not intended to limit the amount of detail or the manner of presenting the information, and subclassifications or additional classifications may be useful.

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7. Realized gains and losses on investments that were both bought and sold during the period should be included.

Additional Financial Statement Disclosures

4.25. Disclosure of a health and welfare benefit plan's accounting policies should include—[8]

a. A description of the methods and significant assumptions used to determine the fair value of investments and the reported value of contracts with insurance companies (if any).

b. A description of significant actuarial assumptions used to determine the plan's liabilities. Any significant changes of assumptions between financial statement dates should be described.

4.26. The plan's financial statements should also disclose, if applicable—

a. A brief, general description of the plan agreement, including, but not limited to, vesting and benefit provisions. If a plan agreement or a description thereof providing this information is otherwise published or made available, the description in the financial statement disclosures may be omitted provided that the reference to the other source is made.

b. A description of significant plan amendments adopted during the period as well as the significant effects on plan liabilities of such factors as plan amendments, changes in the nature of the plan (for example, a plan spin-off or merger with another plan), and changes in actuarial assumptions.

c. The funding policy, and any changes in the policy during the plan year, and, if there is a deficit in net assets of the plan, the method of funding the deficit as provided for in the plan agreement or collective bargaining agreement.[9] For a contributory plan, the disclosure should state the method of determining participants' contributions.

d. The policy regarding the purchase of contracts with insurance companies that are excluded from plan assets.

e. The federal income tax status of the plan, if a favorable letter of determination has not been obtained or maintained.

f. Identification of investments that represent 5 percent or more of total plan assets.

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8. See APB Opinion no. 22, *Disclosure of Accounting Policies*.

9. If significant costs of plan administration are being absorbed by the employer, that fact should be disclosed.

g. Significant real estate or other transactions in which the plan and any of the following parties are jointly involved: the sponsor, the plan administrator, employers, or employee organizations.

h. Unusual or infrequent events or transactions occurring after the financial statement date, but before issuance of the financial statements, that might significantly affect the usefulness of the financial statements in an assessment of the plan's present and future ability to pay benefits. For example, a plan amendment adopted after the latest financial statement date that significantly increases future benefits that are attributable to employee's service rendered before that date should be disclosed. If reasonably determinable, the effects of such events or transactions should be disclosed. If such effects are not quantified, the reasons why they are not reasonably determinable should be disclosed.

Chapter 5

Planning the Examination

5.1. The first standard of field work requires that the auditor's examination be adequately planned and that assistants, if any, be properly supervised (SAS No. 1, sec. 310, "Adequacy of Planning and the Timing of Field Work," and SAS No. 22, *Planning and Supervision*). Planning an examination of the financial statements of an employee benefit plan involves the development of an overall strategy for the expected conduct of the examination. The nature, extent, and timing of audit planning vary with such factors as the type of employee benefit plan, size and complexity of the plan's operations, and any restrictions placed on the auditor's examination.

5.2. When the auditor of the financial statements of an employee benefit plan is also the auditor of the financial statements of the sponsoring employer, it may be more efficient for him to coordinate the examinations, particularly with regard to the testing of payroll and other participant data.

Communication and Coordination

5.3. Communication and coordination considerations are a significant aspect of the audit planning for an examination of the financial statements of an employee benefit plan because of the many parties who are normally involved, for example, the plan sponsor, trustees, administrator, investment trustee, insurance company, other independent auditors, actuary, and attorney.

Information Gathering

5.4. The early stage of audit planning for an examination of the financial statements of an employee benefit plan ordinarily is concerned with information gathering. The auditor's principal objective at this stage is to obtain sufficient information to identify the significant aspects of the engagement. The auditor should consider applying the following procedures to gather information for planning the engagement:

a. Discuss with the trustees, plan administrator, or other appropriate representative of the plan the scope of the examination, including whether it will be restricted, for example, to exclude financial information certified by a bank or insurance carrier. The types of reports and services to be rendered should also be discussed. The auditor is encouraged to prepare an engagement letter to provide a written record of the agreement with the client, particularly (1) in an initial engagement, (2) when the scope of the examination is limited or changed from the previous examination, or (3) when there has been a change in the management of the plan.

b. Inquire about—
   1. Whether the plan's financial statements will be prepared in conformity with generally accepted accounting principles or with another basis of accounting permitted by ERISA or DOL regulations (see paragraphs 12.10 through 12.13).
   2. Whether investment assets are held by outside custodians. The auditor should determine the location of investments and the nature of safekeeping arrangements, including whether the investments are held in the name of the plan.
   3. Whether, and how, the plan's accounting records and participants' data are maintained by the plan sponsor, by a bank, by an insurance carrier, or by other outside parties.
   4. Whether EDP equipment or an outside EDP service is used.
   5. Whether periodic financial statements are prepared.
   6. Whether the plan maintains a list of "parties in interest," as defined by ERISA sec. 3(14).
   7. Whether the plan has procedures for identifying reportable transactions as defined by ERISA and applicable DOL regulations.
   8. Which entities have employees who are participants in the plan.

c. Read the plan instrument, including amendments, to determine, among other things, whether the plan is (1) single-employer or multiemployer, (2) contributory or noncontributory, and (3) funded or unfunded.

d. Read agreements with trustees, investment advisers, and insurance companies to determine whether the plan is a self-insured, insured, or split-funded plan. If the plan is an insured or split-funded plan, determine the type of insurance contract, for example, deposit administration, immediate participation guarantee, or individual policy.

e. Review the prior-year annual report, filings with the IRS and DOL including related correspondence, and the status of IRS determination letters and DOL advisory opinions, if any.

f. Determine the extent of involvement, if any, of specialists, consultants, internal auditors, and other independent auditors.

g. Read reports from the plan's actuary, bank or trustee, insurance company, other independent auditors, and internal auditors.

First Examinations

5.5. If the auditor did not examine the plan's financial statements for the prior year, he should apply procedures that are practicable and reasonable in the circumstances to obtain reasonable assurance that the accounting principles used by the plan in the current and the preceding year are consistent. If the plan has maintained adequate records, the auditor ordinarily should be able to apply appropriate auditing procedures to express an opinion regarding consistency (see SAS No. 1, sec. 546.14).

5.6. Certain areas require special consideration in a first examination of an employee benefit plan's financial statements. The auditor should consider the completeness of participants' data and records of the prior year, especially as they relate to participant eligibility, amounts and types of benefits, eligibility for benefits, and individual account balances. The nature, timing, and extent of auditing procedures applied by the independent auditor are a matter of judgment and will vary with such factors as the adequacy of past records, the significance of beginning balances, and the complexity of the plan's operations.

Chapter 6

Internal Accounting Control

6.1. Generally accepted auditing standards require that the auditor study and evaluate the internal accounting controls of an employee benefit plan to establish a basis for reliance thereon in determining the nature, timing, and extent of audit tests to be applied in the examination of the plan's financial statements. (See SAS No. 1, sec. 320.)

Study and Evaluation of Internal Accounting Control

6.2. Employee benefit plans normally have internal accounting controls that are similar to those found in other entities. A plan's internal accounting controls, however, may involve systems and procedures established and maintained by trustees, banks, insurance companies, plan sponsors, and contract administrators in addition to those established and maintained by the plan. Accordingly, in the study and evaluation of internal accounting control, the plan auditor should consider controls over significant plan assets and records regardless of the location of the assets and records.[1]

6.3. The preliminary phase of the review of the plan's system ordinarily is achieved through discussion with appropriate plan personnel, reference to documents such as the plan instrument, procedural manuals, job descriptions, flowcharts, and decision tables, and previous experience with the plan. When certain internal accounting controls are maintained by third parties, the plan aud-

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1. The procedures underlying an insurance company's records regarding DA and IPG contracts ordinarily are not considered part of the plan's internal accounting control system.

itor may need to review those controls to achieve the objectives of the study and evaluation of internal accounting control set forth in SAS No. 1, sec. 320. When an independent accountant engaged by the third party has reported on its controls, the plan auditor ordinarily will be able to achieve his objectives by reading the report of the third party's accountant. There may be circumstances, however, when the plan auditor wishes to communicate with the third party's independent accountant in order to determine if additional procedures may be necessary to achieve his objectives.

6.4. If, after the preliminary phase of the review, the auditor intends to rely on the plan's internal accounting controls, he should complete the review of the system to determine whether it may be satisfactory for his purpose. If he is to rely on the plan's internal accounting controls in restricting substantive tests, the auditor should make a preliminary evaluation of specific controls to determine whether they are suitably designed and should perform tests of compliance to obtain reasonable assurance that the controls are in use and operating as planned. In examining the financial statements of an employee benefit plan, the auditor often performs tests of compliance in areas concerning investment activity, participants' data, contributions, and benefit disbursements.

6.5. The auditor should consider the results of the compliance tests in making a final evaluation regarding the degree of reliance that may be placed on the plan's internal accounting controls.

Specific Internal Accounting Control Objectives and Procedures

6.6. Certain internal accounting controls of employee benefit plans deserve special attention. The examples in Appendix C serve primarily to illustrate some of the more important control considerations, including investments, contributions received and related receivables, benefit payments, participants' data and plan obligations, administrative expenses, and reporting.

Chapter 7

Auditing Investments

7.1. The investments of an employee benefit plan often consist of marketable securities, such as common or preferred stocks, bonds, notes, or shares of registered investment companies. Other investments may include real estate, mortgages or other loans, leases, nonmarketable securities, or units of participation in common or commingled trust funds maintained by a bank or similar institution. Investments may also be in the form of deposit administration or immediate participation guarantee contracts and individual or pooled separate accounts maintained by an insurance company. Paragraphs 7.2 through 7.15 discuss the auditing objectives and related auditing procedures for examining trusteed assets, and paragraphs 7.16 through 7.34 discuss the auditing objectives and related auditing procedures for examining plan assets held with an insurance company.[1] Paragraphs 7.35 and 7.36 discuss the auditing objectives and related auditing procedures for examining certain other types of plan investments.

Trusteed Assets

7.2. Although investments are an integral part of the assets and operations of an employee benefit plan, the investment activities

1. See paragraphs 1.14 and 12.14 through 12.16 for a discussion of the scope of the auditor's examination when it is limited with respect to assets held by a bank or insurance company.

ordinarily are administratively distinct from other aspects of the plan because the plan administrator or named fiduciary usually engages a trustee or investment adviser or both.

7.3. In a "directed trust," the trustee acts as custodian of a plan's investments and is responsible for collecting investment income and handling trust asset transactions as directed by the party named as having discretion to make investment decisions, such as the plan administrator, the plan's investment committee, or the plan's investment adviser. A "discretionary trust" differs in that the trustee has discretionary authority and control over investments and is authorized by the plan or its investment committee to make investment decisions. A discretionary trust gives the trustee authority to purchase and sell investment assets within the framework of the trust instrument. There are many variations of investment authority that may be given to the trustee, such as a combination of discretionary and directed arrangements within a trust. Furthermore, a plan may have one or more trusts as well as one or more custodial or safekeeping accounts.

7.4. A trustee generally is responsible for the safekeeping of the investments under his control. Sometimes, however, a plan will not appoint a trustee to maintain custody of the plan's investments but, rather, will self-administer the investments and investment transactions and provide for their safekeeping.

7.5. The auditor should be aware that the auditing procedures will vary according to the nature of the trustee arrangement (discretionary or directed) and the physical location and control of the plan's records and investments.

Auditing Objectives

7.6. The objectives of auditing procedures applied to investments and related transactions are to provide the auditor with a reasonable basis for concluding—

a. Whether all investments are recorded and exist.

b. Whether investments are owned by the plan and are free of liens, pledges, and other security interests or, if not, whether the security interests are identified.

c. Whether investment principal and income transactions are recorded and investments are properly valued in conformity with generally accepted accounting principles.

General Auditing Procedures

7.7. The auditing procedures to be applied to the investments of a plan ordinarily should include—

a. Obtaining an analysis of changes in investments during the period. The analysis ordinarily will include such information as (1) the name of the issuer, (2) a description of the investment, including the number of shares of stock, par value of bonds, principal amount of mortgages, maturity date, interest rate, and collateral, (3) cost and fair value at the beginning and end of the period and the basis of determining the fair value, and (4) cost of investments acquired and proceeds of dispositions of investments during the period.

b. Obtaining evidence regarding the existence and ownership of investments and information about any liens, pledges, or other security interests, either by physical count (when securities are held in the plan or employer's vault or safe deposit box and registered in the name of the plan or its nominee) or by direct confirmation from the trustee or custodian. With respect to the confirmation procedure, a trustee, such as a bank, is legally responsible for assets held in its trust department. Thus, if a plan's investments are held by a bank's trust department, the auditor ordinarily accepts a confirmation from the bank as evidence of the existence and ownership of the investments. When a confirmation is used, however, the auditor should obtain information regarding the trustee's responsibility and financial capability. Procedures that the auditor may consider include—

   1. Reviewing the trust instrument provisions to determine the trustee's responsibilities.
   2. Determining whether the trustee has insurance covering the plan assets under his control.
   3. Reading recent financial statements of the trustee.

   The auditing procedures in paragraph 7.8 ordinarily will provide additional evidence regarding the existence and ownership of plan assets.

c. Reviewing minutes, agreements, and confirmations for evidence of liens, pledges, or other security interests in investments.

d. For selected investment transactions—

   1. Determining that they were properly authorized.

2. Examining brokers' advices, cash records, and other supporting documentation for the historical cost or selling price, quantity, identification, and dates of acquisition and disposal of the investments.
3. Comparing prices at which purchases and sales were recorded with published market price ranges on the trade dates.
4. Checking the computation of realized gains and losses.

e. Confirming with the plan's brokers the status of any securities that are in transit.

f. Determining whether income accruing from investments during the period has been properly recorded.

g. Testing the fair value of investments by reference to market quotations or other evidence of fair value. If fair value has been determined in good faith by the plan's board of trustees, administrative committee, or other designated party, the plan auditor does not function as an appraiser and should not be expected to substitute his judgment for that of the plan trustees, the plan administrator, or other adviser. Procedures that the auditor should consider applying include—

1. Reviewing and evaluating the plan's methods and procedures for estimating the fair value of investments.
2. Determining whether the plan's methods and procedures for estimating fair value were followed.
3. Testing the underlying documentation supporting the estimates.
4. Applying the procedures in SAS No. 11, *Using the Work of a Specialist*, if the plan uses a specialist to estimate the fair value of its investments.
5. Inquiring if the plan's board of trustees, administrative committee, or other designated party has reviewed and approved estimates of the fair value of plan investments, and reading supporting minutes or other documentation.

h. Testing the computation of net change in fair value.

i. Testing whether the plan's investments or other transactions violate restrictions or limitations imposed by the plan instrument or plan policy.

j. Inquiring whether the plan's investments or other transactions violate applicable laws or regulations. (See Appendix A for a discussion of "party in interest" and "reportable transactions" under ERISA.)

Discretionary Trusts

7.8. If investments are maintained in a discretionary trust arrangement (see paragraph 7.3), the plan auditor should apply the auditing procedures discussed in paragraph 7.7 as appropriate to records maintained by the plan. Under a discretionary trust arrangement, the plan will not have an independent record of transactions executed by the trust, and thus the plan will not be able to maintain controls that achieve the objectives of internal accounting control for those transactions. If the plan auditor intends to rely on internal accounting controls at the trust department as a basis for restricting his substantive tests regarding transactions executed by the discretionary trust, he should do one of the following in order to meet the objectives of the study and evaluation of internal accounting control:

a. If the trustee has engaged an independent accountant to prepare a special-purpose report on the trust department's internal accounting controls (sometimes referred to as a "single-auditor report"), the plan auditor should obtain a copy of the latest available report for use in determining the scope of his procedures (see SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*). Ordinarily it should not be necessary for the plan auditor to review the trust department auditor's single-audit working papers, provided that the plan auditor is satisfied with the professional reputation and independence of the trust department auditor (see SAS No. 1, sec. 543.10). Although it normally will not be necessary, some plan auditors may decide that additional tests should be applied to selected transactions of the particular plan they are examining. In those circumstances the plan auditor may arrange for the auditing procedures to be applied by the independent auditor of the bank's trust department.

b. If a special-purpose report on the internal accounting control procedures of the trust department cannot be obtained, the plan auditor should apply appropriate auditing procedures at the trust department to make a study and evaluation of the bank trust department's internal accounting control procedures. In applying those auditing procedures, the plan auditor may consider using the work of the trust department's independent auditor or internal auditor.

If the plan auditor is unable to apply the auditing procedures discussed in this paragraph, he ordinarily should conclude that it will be necessary to express a qualified opinion or disclaim an opinion because of the limited scope of the examination (see SAS No. 2, paragraphs 10 through 13).

Investments in Common or Commingled Trust Funds

7.9. A bank common or commingled trust fund may be used to invest some or all of a plan's assets. A plan generally acquires investment units, sometimes referred to as "units of participation," representing an undivided interest in the underlying assets of the trust. The purchase or redemption price of the units is determined periodically by the trustee, based on the current market values of the underlying assets of the fund. The financial statements of many common and commingled trust funds are examined and reported on by auditors engaged by the bank.

7.10. The objectives of auditing procedures applied to investments in common and commingled trust funds are to provide the auditor with a reasonable basis for concluding—

a. Whether the units of participation held by the plan exist.

b. Whether the units of participation are owned by the plan and are unencumbered.

c. Whether valuation of units of participation at the plan's year-end has been determined in conformity with generally accepted accounting principles.

d. Whether purchase, redemption, and income transactions of the units held by the plan are properly recorded.

7.11. The auditing procedures to be applied to investments in common and commingled trust funds should include—

a. Confirming directly with the trustee the units of participation held by the plan.

b. Examining documents approving and supporting selected investment transactions in units of participation, such as investment committee minutes, trust agreements, or investment guidelines.

c. Obtaining a copy of the current financial statements of the fund and relating the reasonableness of the unit information reported in the fund's financial statements to unit information recorded by the participating plan, including market values, purchase and sales values, and income earned and accrued. In examining documents that provide support for the unit value information, the plan auditor should do the following:

1. If the fund's financial statements have been examined by an independent auditor, the plan auditor should obtain and read the fund's financial statements and the auditor's report. The fund's financial statements need not cover the exact period covered by the plan's financial statements; they should, however, be sufficiently recent to satisfy the plan auditor. The auditor should consider the effect that any reported matters may have on the carrying amount of the units of participation held by the plan, such as restrictions on redemption or subjectively determined values. If the auditor believes that the carrying amount may be impaired, he should consider applying analytical review procedures to the interim financial information of the fund from the date of the fund's audited financial statements.
2. If the common or commingled trust fund's financial statements are not examined by an independent auditor, the plan auditor should obtain a copy of a special-purpose report relating to the common or commingled trust fund's internal accounting control procedures, if such a report is available, or he should apply appropriate auditing procedures at the bank, including making a study and evaluation of the internal accounting control procedures relating to income amounts and unit values determined by the trustee. In applying those auditing procedures, the plan auditor may consider using the work of the bank's independent auditor or internal auditor.

If the plan auditor is unable to apply the auditing procedures discussed in this paragraph, he ordinarily should conclude that it will be necessary to express a qualified opinion or disclaim an opinion because of the limited scope of the examination (see SAS No. 2, paragraphs 10 through 13).

Master Trusts and Similar Vehicles

7.12. A company that sponsors more than one employee benefit plan or a group of corporations under common control may place assets relating to some or all of the plans into one combined trust account, sometimes referred to as a "master trust." Each plan has an undivided interest in the assets of this trust, and ownership is represented by the record of proportionate dollar interest or by units of participation. A bank ordinarily serves as the trustee for a master trust, acts as custodian, and may or may not have discretionary control over the assets.

7.13. Plan administrators normally engage an auditor to report only on the financial statements of the individual plans. The auditing objectives and procedures described in paragraphs 7.6 through 7.8 also apply to the activities of a master trust in which a plan participates. When the same auditor examines the master trust and the individual plans that have some or all of their assets are in the master trust, it will normally be efficient for the auditor first to apply appropriate auditing procedures to the master trust and then to examine how ownership is attributable to the individual plans.

7.14. If the master trust is examined by another independent auditor, the plan auditor should obtain the other auditor's report on the master trust's financial statements. The plan auditor should use this report in a manner that is consistent with his use of the report of another auditor on the financial statements of a common or commingled trust fund (see paragraph 7.11*c*).

7.15. The plan auditor should review the trust instrument to obtain reasonable assurance that the accounting for the undivided interest is consistent with the instrument. If the instrument does not specify the accounting method, the auditor should be satisfied that all administrators of plans participating in the master trust agree with the method of allocation.

Insurance Contracts

7.16. A plan may invest assets with an insurance company pursuant to any of a number of different types of contracts. The nature of the contract will determine the related accounting and regulatory reporting requirements.[2]

7.17. The amounts remitted to an insurance company become the assets of the insurance company, for which it, in turn, assumes an obligation to fulfill the contract terms. This differs from the bank trust arrangement in which the bank holds the assets for the plan

2. As noted in Appendix A, plans funded solely with certain types of insurance contracts are not required under ERISA to prepare financial statements or engage an independent auditor.

as a fiduciary and the assets are not included in the bank's financial statements.[3] The extent to which the assets and transactions related to insurance arrangements are recorded in the plan's financial statements, and the extent of auditing procedures to be applied, depend on the terms of the contract with the insurance company.

7.18. For employee benefit plans, the fundamental basis of distinction in classifying contracts for accounting purposes is *(a)* whether the contributions are currently allocated to purchase insurance or annuities for the individual participants or *(b)* whether some or all of the contributions are accumulated in an unallocated fund to be used to meet benefit payments as they come due or to purchase annuities for participants at retirement or on earlier termination of service with a vested right.[4] Contractual arrangements under which funds are currently allocated to purchase insurance or annuities for individual participants are referred to as "allocated" funding arrangements whereas other arrangements are called "unallocated" funding arrangements. Some contractual arrangements may involve both allocated and unallocated funding. Essentially, allocated contracts are excluded from, and unallocated contracts are included in, plan assets.[5]

7.19. Allocated funding arrangements include insurance or annuity contracts in which the insurer has a legally enforceable obligation to make all benefit payments for which it has received the premiums or requested consideration. Allocated funding instruments can be individual insurance or annuity contracts, group permanent insurance contracts, or conventional deferred group annuity contracts. Some of these contracts may also include unallocated side or auxiliary funds, which ordinarily would be considered plan assets.

7.20. Unallocated funding instruments apply to any arrangement under which employer or employee contributions to an employee benefit plan are held in an undivided fund until they are used to meet benefit payments as they come due or to purchase

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3. See paragraphs 7.26 through 7.29 and 7.33 for a discussion of insurance company separate accounts.
4. Although the term "allocated account" is used by insurance companies in connection with defined contribution plans when amounts are recorded in separate participant accounts, the term "allocated," as it is used here, refers to situations in which defined benefits are guaranteed by the insurance companies.
5. See paragraph 2.9 in this guide as well as FASB Statement no. 35, paragraphs 12 and 112 through 126.

annuities for participants at retirement or on earlier termination of employment with vested benefits. Unallocated funding ordinarily is associated with the deposit administration type of group annuity contract (DA) and the immediate participation guarantee contract (IPG).[6] For investment purposes, unallocated funds may be commingled in a general or separate account or held in an individual separate account.

7.21. Determining whether contract assets and related obligations should be reported in the plan's financial statements requires a careful review of the contract. Because typical DA and IPG contracts are unallocated funding arrangements, the value of those contracts should be included in a plan's financial statements. Assets held in separate accounts are similarly reflected in the plan's financial statements, since they are unallocated amounts held by the insurance company.

Deposit Administration Contracts

7.22. The term "deposit administration" is applied to a type of contract under which contributions are not currently applied to the purchase of single-payment deferred annuities for individual participants. The concept of the deposit administration arrangement is that all funds intended for the payment of benefits to participants still on the active rolls of the employer are held in an undivided account, generally referred to as the "active life fund." The account is credited with all current contributions, interest, and any dividends or experience rated credits granted. It is charged with the purchase price of all annuities provided for retired participants (and, possibly, vested participants), with any incidental benefits disbursed directly from the account (for example, death, disability, and withdrawal), and with expenses. As each participant reaches retirement, an amount determined by the terms of the plan and the contract is withdrawn from the fund to provide an immediate annuity for the pensioner. The withdrawal is put into an allocated fund, which is not considered a plan asset.

7.23. Although the insurance company will guarantee a minimum stipulated interest rate on funds in the "active life fund" and

6. The term "group annuity" is frequently applied to a broad category of insurance contracts that provide the vehicle for funding pension benefits. Those include "deferred group annuity" contracts, "deposit administration" contracts, and "immediate participation guarantee" contracts.

rates at which annuities may be purchased, it does not guarantee that sufficient funds will be available to meet the cost of annuities to be purchased.

7.24. The dividends or experience rated credits, which arise from the "experience fund," are determined by the insurance company, but they are not guaranteed. The calculation of these credits is based on internal records kept by the insurance company for each contract and are determined by the actual investment experience of the insurance company, mortality and other actuarial experience, and reserves required by the insurance company. Under DA contracts, amounts of dividend or rate credits are determined solely at the discretion of the insurance company, which has no contractual obligation to pay a dividend. The contract holder has no contractual right to demand an accounting.

Immediate Participation Guarantee Contracts

7.25. Immediate participation guarantee contracts have many of the same characteristics as deposit administration contracts; except in IPG contracts—

a. A fixed rate of interest generally is not guaranteed by the insurer, nor is a dividend credited to the fund. Rather, the fund is credited with interest based on the actual rates currently earned by the insurer. Thus there is an immediate participation in the insurer's investment performance instead of a guaranteed interest rate and a rate adjustment or dividend. Interest is generally based on "new money rates," which relate the overall investment to the individual year the funds are invested by the plan. The manner in which companies determine investment years varies.

b. Annuity payments generally are made by using one of the following methods:

1. Monthly benefit payments are made directly from the fund to retirees; thus the fund participates immediately in mortality experience. When, however, the insurer does not actually purchase annuities but guarantees benefit payments when the pensioner retires, a minimum balance sufficient to purchase annuities for all retired participants is required to be maintained in the active life account (unallocated funds). When the insurer does not guarantee benefit payments, no minimum fund balance will be required. Even

though "guaranteed," these arrangements do not meet the criteria for exclusion from plan assets prescribed by FASB Statement no. 35.

2. Similar to the DA plan, annuities may be purchased when the participant retires, and there is an adjustment made to the fund each year on the basis of the insurer's analysis of mortality, benefits paid, and earnings.

Investment Arrangements With Insurance Companies

7.26. A separate account may be used independently of, or as an adjunct to, a deposit administration or immediate participation guarantee contract.

7.27. Separate accounts were developed to allow insured plans to compete with trust funds in making investments and in funding variable annuity plans. The assets of a separate account plan are assets of the insurance company but are not commingled with the insurance company's general assets. The purpose of a separate account is to provide flexibility in the investment of the plan's funds. A separate account may be established solely for one plan or, more commonly, may be pooled with the funds of several plans.

7.28. A separate account in which only one plan participates is generally referred to as an "individual separate account" or as a "separate-separate account." The investments in the account must be separately identified, and the account is operated similarly to a bank trust fund, although it is included in the insurance company's financial statements.

7.29. A separate account in which several plans participate generally is referred to as a "pooled separate account." Each plan's share of a pooled separate account is determined on a participation-unit or variable-unit basis.[7] The plan's equity account provides a cumulative record of the number of participation units credited to the account and the number of units allocated or withdrawn from the account. The balance of participation units credited to the account multiplied by the current participation-unit value equals the amount of equity account assets held on behalf of the policy-

7. In some separate accounts, a plan receives a guaranteed rate of return on funds held in the separate account. Accordingly, a plan's share would be determined by applying the contractual guarantee to the plan's account balance, and the funds held in the separate account should be viewed as an unallocated funding instrument as described in paragraph 7.18.

holder at any given time. The participation-unit value is adjusted periodically, usually each business day, to reflect investment results under the separate account.

Auditing Objectives

7.30. The objectives of auditing procedures applied to plan assets held with an insurance company are to provide the auditor with a reasonable basis for concluding—

a. Whether plan assets, represented by insurance contracts, exist, and whether changes in plan assets during the period are properly recorded and valued in conformity with generally accepted accounting principles.

b. Whether the terms of the contract are being complied with and are appropriately disclosed in the plan's financial statements.

Auditing Procedures

7.31. The auditing procedures to be applied to insurance contracts (to the extent they are applicable to a particular contract) ordinarily should include—

a. Reading the contracts between the contract holder and the insurance company.

b. Confirming the following directly with the insurance company, as applicable:

  1. Contributions or premium payments made to the fund or account during the year
  2. Interest, dividends, refunds, credits, and changes in value and whether such amounts have been charged or credited during the year on an estimated or actual basis
  3. The contract value of the funds in the general account or the fair value of the funds in the separate account at the plan's year-end and the basis for determining such values
  4. The amount of insurance company fee and other expenses chargeable during the year
  5. For insurance contracts with unallocated funds, annuity purchases or benefits paid from unallocated plan assets during the year
  6. Transfers between various funds and accounts

c. Evaluating whether the characteristics of the contract that restrict the use of assets require disclosure in the financial statements of the plan.

7.32. For contracts in which assets are held in the insurance company's general account (DAs and IPGs), the following additional auditing procedures should be applied:

a. For DA contracts, evaluating the reasonableness of the interest credited to the contracts in relation to any minimum guaranteed interest rate stated in the contract.[8]

b. For IPG contracts, considering the plan administrator's conclusion regarding the basis for recording changes in contract values to recognize investment returns in accordance with the terms of the contract. This conclusion is usually made by referring to investment yield data furnished the plan by the insurance company. Generally, this evaluation would sufficiently satisfy the auditor regarding the aggregate investment income credited to the contract. If the amount of investment yield credited to the contract, based on current investment returns, does not appear reasonable, the auditor should apply additional procedures, such as making inquiries of the insurance company regarding its compliance with the method required under the terms of the contract for computing investment return. In the event that the plan auditor is unable to obtain assurance as to the reasonableness of the rate of investment return credited, he should consider requesting the plan administrator to contact the insurance company to arrange for the insurer's independent auditor to perform agreed-upon procedures and issue a report thereon (see SAS No. 35). Those procedures would be applied to the insurance company's determination of investment returns in accordance with the contract.

c. Determining that annuity purchases were made on the basis of rates stipulated in the contract. If annuities are not purchased and benefits are paid directly from the fund, benefit payments should be tested in accordance with the auditing procedures discussed in paragraph 9.3.

d. Reading the financial statements of the insurance company.

e. Evaluating whether expenses charged to the contract by the insurance company are in accordance with the insurance contract or are otherwise authorized by the plan.

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8. The plan auditor need not apply auditing procedures to the experience fund of a typical DA account or to any similar fund that is used by the insurance company to determine a "discretionary" dividend or rate credit under the contract (see paragraph 7.24).

7.33. For insurance contracts in which investments are made in *separate accounts*, the auditor should apply the following additional procedures:

a. For investments in which assets are held in *individual separate accounts*, the plan auditor's examination should include the individual investment transactions and documents that provide support for those transactions. To perform those procedures, the plan auditor should do the following:
   1. If the separate account's financial statements have been examined by an independent auditor, the plan auditor should obtain and read the separate account's financial statements and the auditor's report. The financial statements need not cover the exact period covered by the plan's financial statements; they should, however, be sufficiently recent to satisfy the plan auditor.
   2. If the separate account's financial statements have not been examined by an independent auditor, the plan auditor should obtain a copy of a special-purpose report on the insurance company's internal accounting control procedures relating to its separate account activities, if such a report is available, or he should apply appropriate procedures at the insurance company, including making a study and evaluation of the internal accounting control procedures relating to the separate account. In applying those auditing procedures, the plan auditor may consider using the work of the insurance company's independent auditor or internal auditor.

b. For investments in *pooled separate accounts*, the plan auditor's examination is concerned with the plan's units of participation in the pooled account, and the plan auditor should examine documents that provide support for those transactions. To perform those procedures, the plan auditor should do the following:
   1. If the pooled account's financial statements have been examined by an independent auditor, the plan auditor should obtain and read the pooled account's financial statements and the auditor's report. The financial statements need not cover the exact period covered by the plan's financial statements; they should, however, be sufficiently recent to satisfy the plan auditor. The auditor should consider the effect that any reported matters may have on the carrying amounts of

the units of participation held by the plan, such as restrictions on redemption or subjectively determined values. If the auditor believes the carrying amount may be impaired, he should consider applying analytical review procedures to the interim financial information of the pooled account from the date of the account's audited financial statements.

2. If the pooled separate account's financial statements have not been examined by an independent auditor, the plan auditor should obtain a copy of a special-purpose report on the insurance company's internal accounting control procedures relating to the pooled account's activities, if such a report is available, or he should apply appropriate procedures at the insurance company, including making a study and evaluation of the internal accounting control procedures relating to income amounts and unit value information determined by the insurance company. In applying those auditing procedures, the plan auditor may consider using the work of the insurance company's independent auditor or internal auditor.

7.34. If the plan auditor is unable to apply the auditing procedures discussed in paragraphs 7.31 through 7.33, he ordinarily should conclude that it will be necessary to express a qualified opinion or disclaim an opinion because of the limited scope of the examination (see SAS No. 1, paragraphs 10 through 13).

Other Investments

7.35. The objectives of auditing procedures applied to other types of investments and related transactions are to provide the auditor with a reasonable basis for concluding—

a. Whether all investments are recorded and exist.

b. Whether investments are owned by the plan and are free of liens, pledges, and other security interests or, if not, whether the security interests are identified.

c. Whether investment transactions are recorded and investments are properly valued in conformity with generally accepted accounting principles.

7.36. The auditing procedures to be applied to other types of investments ordinarily should include—

a. For real estate—
  1. Examining closing and other documents supporting the cost of ownership.
  2. Examining deeds, title policies, and other evidence of ownership.
  3. Evaluating the reasonableness of the fair value (see paragraph 7.7*g*).
  4. Examining current-year tax bills and relating them to property descriptions under (2) above.
  5. Testing investment income from real estate, such as rents, and payments of related expenses, such as taxes and maintenance.
  6. Inquiring whether the plan's investments or other transactions violate applicable laws or regulations. (See Appendix A for a discussion of "party in interest" and "reportable transactions" under ERISA.)

b. For loans and mortgages—
  1. Examining documents, including notes, mortgages, deeds, and insurance policies, supporting selected loans and mortgages.
  2. Confirming selected loans and mortgages with borrowers.
  3. Evaluating the reasonableness of the fair value, including the extent of collateral, if any (see paragraph 7.7*g*).
  4. Testing to see that interest is properly recorded.
  5. Inquiring whether the plan's investments or other transactions violate applicable laws or regulations. (See Appendix A for a discussion of "party in interest" and "reportable transactions" under ERISA.)

Chapter 8

Auditing Contributions Received And Related Receivables

8.1. For all types of employee benefit plans, the basis for determining employer and, if applicable, employee contributions is specified in the plan instrument or related documents. For defined benefit plans covered by ERISA, employer annual contributions must also satisfy the minimum funding standards of ERISA. (See Appendix A for a discussion of the funding standard account and minimum funding standards of ERISA.)

Auditing Objectives

8.2. The objectives of auditing procedures applied to contributions received and related receivables of employee benefit plans are to provide the auditor with a reasonable basis for concluding—

a. Whether the amounts received or due the plan have been determined and recorded in conformity with generally accepted accounting principles.

b. Whether an appropriate allowance has been made for uncollectible plan contributions receivable.

Auditing Procedures

8.3. The auditing procedures to be applied to employer and employee contributions ordinarily should include—

a. Obtaining a list of participating employers (in a multiemployer plan) and testing its completeness by examining appropriate plan documents.

b. Obtaining a schedule of contributions received or receivable and relating the contributions to the listing of participating employers obtained in procedure (*a*) above.

c. Testing, for a selected number of contribution reports, to see that the reports are arithmetically correct and that the contribution rate specified in the plan instrument, including collective bargaining agreements, if applicable, was used.

d. Reconciling contributions received from the schedule obtained in procedure (*b*) to the plan's cash receipts records and bank statements or trustee reports. Sometimes a central bank account is used for the deposit of employer contributions to several related employee benefit plans. In those circumstances it may be necessary to test the amounts transferred to the bank account of the individual employee benefit plan.

e. Testing postings from the employer contribution reports to the participant employee or employer records and from participant records to contribution reports.

f. Confirming directly with contributors, on a test basis, amounts received and receivable.

g. Reviewing criteria used by the plan in accruing employer and employee contributions receivable and determining that the accruals have been recorded in accordance with generally accepted accounting principles.

h. Evaluating the reasonableness of the plan's allowance for doubtful accounts.

8.4. The auditor may find that he can accomplish the foregoing procedures more efficiently by coordinating his auditing procedures for plan contributions with those for participants' data (see chapter 10). In examining the financial statements of a multiemployer plan, the auditor may need to make special arrangements to examine employer records. The auditing procedures and related guidance described in paragraph 10.6 may be applicable in those circumstances (see also paragraph 12.17).

Defined Benefit Pension Plans

8.5. Besides the auditing procedures discussed in paragraph 8.3, additional procedures that the auditor should consider applying in examining the financial statements of a defined benefit pension plan include—

a. Determining that employer contributions are consistent with the report of the plan's actuary.

b. Reviewing the amount contributed and, if applicable, determining that it meets the requirements of the funding standard account. (See Appendix A for a discussion of the funding standard account.)

c. Considering the results of the auditing procedures described in chapter 10 for participants' data and using the work of an actuary when examining the amount recorded as contributions in the plan's financial statements. For example, significant errors in participants' data provided to the actuary may have a material effect on the amount of contributions presented in the plan's financial statements.

Defined Contribution Plans and Health and Welfare Benefit Plans

8.6. Besides the auditing procedures discussed in paragraph 8.3, additional procedures that the auditor should consider applying in examining contributions to defined contribution and health and welfare benefit plans include—

a. Reviewing the contribution provisions of the plan instrument and testing, when appropriate, compliance with the plan instrument. (The plan instrument of a defined contribution plan often specifies the criteria that must be met for the employer and employee to make a contribution, the formula to determine upper and lower contribution limits, or the rates for determining the contribution.)

b. Comparing the amount recorded in the plan's records to the amount approved by the board of directors, if the plan instrument requires that the board of directors determine or approve the employer contribution.

c. Considering, if applicable, the results of the auditing procedures described in chapter 10 for participants' data and using the work of an actuary when examining the amount recorded as contributions in the plan's financial statements. For example, significant errors in participants' data provided to the actuary may have a material effect on the amount of contributions presented in the plan's financial statements.

Chapter 9

Auditing Benefit Payments

9.1. The amount and manner of benefits paid or payable to participants are determined in accordance with the plan instrument or related documents. The plan administrator or his agent is responsible for the disbursement of plan assets to satisfy the requirements set forth in the plan instrument.

Auditing Objectives

9.2. The objectives of auditing procedures applied to benefit payments for employee benefit plans are to provide the auditor with a reasonable basis for concluding—

a. Whether the amounts of the authorized payments are in accordance with plan provisions.

b. Whether the payments are made to persons entitled to them and only to such persons (that is, that benefit payments are not being made to deceased beneficiaries or to persons other than beneficiaries.)

Auditing Procedures

9.3. To evaluate whether benefit payments have been determined in accordance with plan provisions, the auditor ordinarily should apply auditing procedures, such as—

a. For selected participants receiving benefit payments—

1. Examining the participant's file for type of claim and propriety of approvals and tracing approval of benefit payments to board of trustees or administrative committee minutes.
2. Evaluating the participant's eligibility (that is, whether the plan's provisions were fulfilled for benefit payments) by examining appropriate evidence of age and employment his-

tory data; comparing employment dates, credited service, and earnings to payroll records; and examining the benefit election form to determine method of distribution (for example, lump sum, installments, or annuity contract).

3. For plan benefits such as death and disability benefits, examining a copy of the death certificate and beneficiary form, physician's statement, and other appropriate documents.
4. Recomputing benefits based on the plan instrument provisions and option elected and pertinent service or salary history.
5. Comparing the amount of benefit payment to cash disbursement records or trustee reports.

b. Evaluating the continued eligibility of participants or beneficiaries to receive benefits to assure that individuals are removed from the benefit rolls upon death and that payments made to individuals over an unusually long number of years are still appropriate.

c. Evaluating whether procedures exist for investigating long-outstanding benefit checks.

d. Comparing, for defined contribution plans, disbursements to participants with individual participant's account records that have been examined in accordance with the auditing procedures in paragraphs 10.9 through 10.11.

Depending on the auditor's evaluation of the procedures described in (*b*) above, the auditor may also wish to compare canceled checks with the plan's cash disbursement records or to confirm payment of benefits by corresponding directly with selected participants or beneficiaries and comparing signatures with the application for plan benefits or with other appropriate plan documents.

9.4. In some circumstances, benefit disbursements are determined or made by a third party such as a bank, insurance company, or other service provider. The use of such a third party's independent auditor to perform certain of the foregoing procedures may be appropriate in those circumstances.

Chapter 10

Auditing Participants' Data and Plan Obligations

Participants' Data

10.1. The nature of plan benefit obligations and the accounting methods and auditing procedures for them differ among the three types of plans; however, each type requires the testing of certain participants' data. Although the type of participants' data to be tested differs according to the type of plan, and from plan to plan within each type, the data used to determine accumulated plan benefits will be identified in the plan instrument and collective bargaining agreement, if applicable. If the plan requires the services of an actuary, the actuarial report may also describe or summarize the participants' data used by the actuary. The data should be tested by the auditor in accordance with SAS No. 11, *Using the Work of a Specialist* (see paragraphs 10.18 through 10.23 and 10.32 and 10.33).

10.2. The objectives of auditing procedures applied to participants' data are to provide the auditor with a reasonable basis for concluding—

a. Whether covered employees have been properly included in employee eligibility records and, if applicable, in contribution reports.

b. Whether accurate participants' data for eligible employees were supplied to the plan administrator and, if appropriate, to the plan actuary.

10.3. The period for which the data are tested will depend on the date as of which the related financial information is presented in the financial statements. For example, if the accumulated plan benefits are actuarially valued as of the beginning of the plan year, the data to be tested will be as of or for the period ending as of that date. Similarly, if contributions are determined on the basis of an actuarial valuation as of the beginning of the plan year, data submitted to the actuary and to be tested by the auditor would be as of that date. If the auditor also examines the employer's financial statements, the auditing procedures applied in the prior year's examination of the employer's financial statements generally need not be duplicated in the examination of the plan's financial statements. The auditor may find that he can accomplish his work more efficiently by coordinating his auditing procedures for participants' data with procedures for plan contributions and plan benefits described in chapters 8 and 9.

10.4. The types of participants' data that ordinarily should be tested in an audit of a plan's financial statements will vary from plan to plan, depending on the factors on which contributions and benefits are determined. In general, the data tested may include—

a. Demographic data, such as sex, marital status, birth date, period of service with the employer, and other service history.

b. Payroll data, such as wage rate, hours worked, earnings, and contributions to the plan, if any.

c. Benefit data for participants receiving benefits, such as benefit levels and benefit options selected.

10.5. In testing the employer's participants' records, procedures that should be considered include—

a. Reviewing pertinent sections of the plan instrument and collective bargaining agreement, if applicable, as a basis for considering what participants' data should be tested in the audit of the plan's financial statements.

b. Testing the summarization of the payroll journal and schedules of participants' data, if applicable, and tracing postings of gross pay to general or subsidiary ledger accounts.

c. Testing payroll data for one or more pay periods and for a number of participants by—
   1. Tracing the individual payrolls from the payroll journal to the participants' earnings records.
   2. For participants paid on an hourly or piecework basis, testing payroll hours, production tickets, or other supporting evidence and testing the computation of hours.

3. Testing rates of pay to authorizations or union contracts.
4. Testing calculations of earnings.
5. Examining personnel files for hiring notice and employment data, pay rates and rate changes, termination notice, sex, birth date, and so forth.

d. If participant files are maintained in the custody of the plan administrator, testing whether the data maintained in those files correspond to the data maintained in employer payroll and personnel files.

For multiemployer plans, in addition to the procedures described in (*a*) through (*d*) above, the auditor should consider comparing the employer's contribution reports with the information shown in participants' earnings records and comparing hours worked and earnings records with the employers' contribution reports to evaluate whether the participants have been properly included in or excluded from the reports. If significant participants' data are missing or incomplete, the auditor should inquire about the methods used by the plan administrator or plan actuary to give effect to such missing data.

10.6. If the auditor is unable to examine the participants' records, which may occur in a multiemployer plan, there may be circumstances, depending on the existing control environment, in which the auditor can obtain the necessary assurance by applying one or more procedures, such as—

a. If the plan administrator maintains records of participants' data and maintains internal accounting controls to help ensure that data on all participants are included in the records, testing the data on which contributions and actuarially determined amounts are based by direct communication with participants and by comparison with union records, if applicable. The auditor may also confirm hours, pay rates, and other appropriate information.

b. If the plan administrator, as part of his normal procedures, periodically visits employers to test data submitted to him, reviewing and testing the plan administrator's procedures.

c. Obtaining a special report from the auditor of the employer company stating that appropriate auditing procedures (as described above) have been performed, and obtaining the auditor's conclusions regarding the procedures applied. In addition, the plan auditor should apply such other auditing procedures as he considers necessary in the circumstances. In this regard, it may be necessary for the plan auditor to request the other auditor to apply additional tests (see SAS No. 1, sec. 543).

If the auditor is unable to obtain the necessary assurance regarding participants' data, he ordinarily should conclude that it will be necessary to express a qualified opinion or disclaim an opinion because of the limited scope of the examination (see paragraph 12.17 and SAS No. 2, paragraphs 10 through 13).

Defined Benefit Plans

10.7. Contributions to a defined benefit plan ordinarily are determined on the basis of an actuarial valuation of the plan carried out by the plan actuary, using participants' data received from the plan administrator or the employer company and using actuarial techniques. For multiemployer plans and certain other negotiated plans, contribution levels are normally specified in the plan instrument or collective bargaining agreement, and an actuarial valuation is used to compare accumulated contributions to date with accumulated plan benefits. SAS No. 11, paragraph 8 states, "The auditor should consider whether the specialist's findings support the related representations in the financial statements and make appropriate tests of accounting data provided by the client to the specialist." Accordingly, the auditor should satisfy himself that the participants' data provided to and used by the actuary were accurate and complete in all material respects.

10.8. In addition to the auditing procedures described in paragraphs 10.1 through 10.6, when examining the financial statements of defined benefit plans that involve actuarial valuations, the auditor should apply auditing procedures that include—

a. Tracing information obtained during tests of participants' data to the participants' data given by the plan administrator to the actuary.

b. Testing the reliability of the basic data used by the actuary in his calculations (for example, name, sex, birth date, hours worked, employment dates, dates of participation in plan, and salary) by tracing data from the actuary's report (if it is shown in the report) or from a confirmation letter obtained from the actuary to the data furnished by the plan. This test would normally include a selection of individuals as well as summary totals (see paragraph 10.20g).

Defined Contribution Plans

10.9. For defined contribution plans, the types of participants' data that should be tested will vary from plan to plan. The data tested generally should include—

a. Covered compensation of individual participants. IRS regulations generally require that the company contribution be allocated to participants on the basis of the ratio of their covered compensation to total covered compensation for all participants.

b. Individual participants' contributions to the plan.

c. Birth date, date of hire, and other demographic data that determine eligibility and vesting.

10.10. In addition to other uses, these data are used to test the validity of terminations and the eligibility of individuals to participate in the plan. Examples of the auditor's procedures in which the data are used are—

a. Tracing individuals who have terminated to benefit payments or to benefits payable and, if forfeitures are involved, to the record of forfeited amounts.

b. For individuals who qualify for participation during the year and who elect to participate, evaluating whether the individuals have been properly included in the individual participant accounts.

10.11. The auditing procedures discussed in paragraphs 10.1 through 10.6 (including procedures relating to the use of the work of an actuary, if applicable) should also be applied to the data.

Health and Welfare Benefit Plans

10.12. The types of participants' data that should be tested in the examination of the financial statements of a health and welfare benefit plan differ widely from plan to plan. In general, the data tested may include—

a. Payroll data, including salary or wage rate and hours worked.

b. Demographic data, including sex, birth date, date of hire, and number of dependents.

c. Claims history records maintained by the plan administrator.

10.13. The auditing procedures discussed in paragraphs 10.1 through 10.6 (including procedures relating to the use of the work of an actuary, if applicable) should also be applied to the data. The use of the data in evaluating eligibility and benefits is discussed in paragraph 9.3.

Plan Obligations

10.14. As discussed earlier in this chapter and in chapters 2 through 4, the nature of plan benefit obligations and the methods of valuing and recording those obligations differ significantly among the three types of plans.

Defined Benefit Plans

10.15. The objective of auditing procedures applied to accumulated plan benefits is to provide the auditor with a reasonable basis for concluding whether the actuarial present value of accumulated plan benefits, components of those benefits, and amounts of changes in the actuarial present value of accumulated plan benefits are presented in conformity with FASB Statement no. 35. That objective is ordinarily accomplished by applying the auditing procedures described in paragraph 9.3 for benefit payments, paragraphs 10.1 through 10.8 for participants' data, and paragraphs 10.18 through 10.23 for using the work of an actuary.

10.16. The actuarial valuation used to determine accumulated plan benefits in accordance with FASB Statement no. 35 is based on the benefit provisions of the plan and on participants' data. For many defined benefit plans the participants' data submitted to the actuary are current only as of the beginning of the plan year. The practice of preparing valuations as of the beginning of a plan year developed as a practical expedient to facilitate completion of the valuation on a timely basis. For financial reporting purposes, the information may be presented either as of the beginning or the end of the plan year; FASB Statement no. 35 states, however, that an end-of-year benefit information date is considered preferable.

10.17. In the event that an actuarial valuation has not been prepared as of the beginning or the end of the plan year, the plan administrator may nevertheless prepare financial statements using estimated accumulated benefit information as contemplated by FASB Statement no. 35. If the benefit information is so estimated, the auditor should assure himself that the methods and assumptions used to estimate the accumulated benefit information are reasonable in the circumstances, and he should apply the procedures set forth in SAS No. 11.

Using the Work of an Actuary

10.18. The independent auditor's qualifications do not encompass actuarial science or the complexities of probability and longevity associated with life contingencies. The auditor may have a general awareness and understanding of actuarial concepts and practices; he does not, however, purport to act in the capacity of an actuary. The auditor, therefore, needs to follow the guidance of SAS No. 11, *Using the Work of a Specialist,* to obtain assurance regarding the work of an actuary on such matters as plan contributions (see chapter 8) and accumulated benefit valuations.[1]

10.19. An examination of plan financial statements requires cooperation and coordination between the auditor and the plan actuary. The auditor uses the work of an actuary as an audit procedure to obtain competent evidential matter; the auditor does not simply rely on the report of an actuary. Although the appropriateness and reasonableness of the methods and assumptions used, as well as their application, are within the expertise of the actuary, the auditor does not divide responsibility with the actuary for his opinion on the financial statements taken as a whole. Thus, the auditor should satisfy himself as to the professional qualifications and reputation of the actuary, obtain an understanding of the actuary's methods and assumptions, test accounting data provided to the actuary, and consider whether the actuary's findings support the related representations in the financial statements. Ordinarily, the auditor would use the work of the actuary unless his auditing procedures lead him to believe that the findings were unreasonable in the circumstances. Sometimes it may be necessary for the auditor to obtain the services of an actuary other than the one who prepared the plan's actuarial valuation. This might occur when the plan actuary is related to the plan or when the auditor believes that the determinations made by the plan actuary are unreasonable.

1. With regard to actuarial services provided a client by the auditor's firm, a related ethics ruling under the AICPA Rules of Conduct states, "Even though the member's firm provides actuarial services (the results of which are incorporated in the client's financial statements), if all of the significant matters of judgment involved are determined or approved by the client and the client is in a position to have an informed judgment on the results, the member's independence would not be impaired by such activities." [Ethics Ruling on Independence, Integrity and Objectivity, no. 54, "Member Providing Actuarial Services," *AICPA Professional Standards*, vol. 2, ET sec. 191.108.]

10.20. With respect to the actuarial present value of accumulated plan benefits and changes therein (as well as contributions), the auditor, in following the guidance in SAS No. 11, should—

a. Obtain satisfaction regarding the professional qualifications of the actuary. If the actuary is not known to the auditor, the auditor should consider other factors that might provide him with evidence regarding the actuary's qualifications. Examples of factors to consider are whether the actuary is an "enrolled actuary" under ERISA secs. 3041 and 3042; the actuary's membership in a recognized professional organization; and the opinion of other actuaries, whom the auditor knows to be qualified, regarding the actuary's professional qualifications.[2]

b. Obtain an understanding of the actuary's objectives, scope of work, methods, and assumptions, and their consistency of application. For defined benefit plans the auditor should ascertain whether the method and assumptions used in the accumulated plan benefit information are in conformity with FASB Statement no. 35 and whether the funding method and assumptions are in accordance with ERISA.

c. Inquire whether the actuarial valuation considers all pertinent provisions of the plan, including any changes to the plan or other events affecting the actuarial calculations.

d. Inquire about the nature of any relationship the actuary may have with the plan or the employer company that may impair his objectivity. This can usually be accomplished by requesting the client to have the actuary describe in writing the relationship, if any, that may exist and that may appear to impair the objectivity of his work. The engagement of a consulting actuary to perform valuations on behalf of plan participants or a sponsor company ordinarily is not a relationship that would impair the objectivity of the actuary. If the actuary is related to the client, or if the auditor is unable to determine that the actuary has no relationship with the client that might impair his objectivity, the auditor should consider performing additional auditing procedures regarding some or all of the actuary's methods and

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2. There are no universal standards for establishing the professional qualifications of an actuary. Some actuaries specialize in or concentrate on pension matters; others confine their practice to life or property and liability insurance matters. Qualification, by education and experience, to practice in one of these areas does not necessarily prepare the actuary to practice in other areas.

assumptions to determine that the findings are not unreasonable.

e. Inquire whether the actuary has reviewed the relevant portions of the financial statements and agrees with the reference to his work in the financial statements.

f. Test the reliability and completeness of the census data provided by the plan and used by the actuary in his actuarial valuation. These tests may be coordinated with the auditing procedures described in paragraphs 8.3 through 8.5 for plan contributions and 10.1 through 10.8 for participants' data. In the event that data provided to the actuary are significantly incomplete, the auditor should inquire of the actuary in regard to the treatment of the incomplete data and should determine if the method used by the actuary to give effect to the missing data in his valuation is reasonable in the circumstances. This situation is most likely to occur in multiemployer plans.

g. Confirm aggregate participants' data used in the actuarial valuation. (The auditor may wish to include this request as part of his audit inquiry letter to the plan's actuary.) In addition, the auditor may also wish to confirm information related to selected individual participants that is part of the aggregate amounts.

10.21. The auditor should request the plan administrator to send a letter to the plan's actuary requesting that the actuary (*a*) provide the auditor with a copy of his actuarial report, Schedule B of Form 5500, or comparable information or (*b*) confirm to the auditor the actuarial information that has already been obtained from the plan in connection with the audit.

10.22. An illustration of a letter to the plan's actuary requesting a copy of the actuary's report or other information on the plan appears as exhibit A, pp. 69–71. In situations in which the auditor also examines the financial statements of the sponsor company, he should consider combining the request for this information with his request for information necessary for compliance with APB Opinion no. 8, *Accounting for the Cost of Pension Plans*, and FASB Statement no. 36, *Disclosure of Pension Information*.

10.23. An illustration of a letter to the plan's actuary requesting confirmation of information taken from the actuary's report or the plan's or the sponsor company's records appears as exhibit B on p. 72.

Exhibit A—Illustrative Letter to Plan Actuary

In connection with an examination of the financial statements of XYZ Pension Plan [*date of statements*], please furnish our auditors, [*name and address*], the information described below as of [*the more recent benefit information date, either the date of the plan year-end or the date of beginning of plan year*]. For your convenience, you may supply in response to these requests pertinent sections, properly signed and dated, of your actuarial report or Schedule B, if available and if the requested information is contained therein.

a. Please indicate the actuarial present value of accumulated plan benefits as defined in FASB Statement no. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* classified as follows:

1. Vested benefits of participants and beneficiaries currently receiving payments $________
2. Other vested benefits $________
3. Nonvested benefits $________
4. Total $________

b. The date of the above valuation of accumulated plan benefits is ___.

c. Describe the principal assumptions used in determining the actuarial present value of accumulated plan benefits.

d. Please indicate the minimum annual contribution, including the use of any credit balances in the funding standard account available to offset present or future contributions under ERISA and the actuarial cost method being used; a description of the actuarial assumptions used in computing the funding standard account; and the aggregate effect of any change in the method or assumption(s). Also, indicate whether the alternative funding standard account was elected and whether the full-funding limitation is applicable.

e. Briefly describe the employee group covered.

f. Please provide the following:

1. A brief general description of the benefit provisions of the plan used in the actuarial calculation
2. A description of any benefits, as prescribed by FASB Statement no. 35, not included in the accumulated plan benefits valuation and the reason therefore
3. The effective date of the last plan amendment included in this valuation

g. Please provide the following information relating to the employee census data used in performing the actuarial valuation:
   1. The date as of which the census data were collected is ______.
   2.

Participants	Number of persons	Compensation (if applicable)
Currently receiving payments	______	______
Active with vested benefits	______	______
Terminated with deferred vested benefits	______	______
Active without vested benefits	______	______
Other (describe)	______	______
Total	______	______

Note: If information is not available for each of the above categories, indicate which categories have been grouped. Please describe any group or groups of participants not included in the above information.

   3. Information for specific individuals contained in the census:

Participant's Name or Number	Age or Birth Date	Sex	Salary	Date Hired or Years of Service

[*Note to auditor: The auditor should select information from employer records to compare with the census data used by the actuary. In addition, the auditor may wish to have selected certain census data from the actuary's files to compare with the employer's records.*]

h. Describe, if significant (either individually or in the aggregate), the effects of the following factors on the change in the actuarial present value of accumulated plan benefits from the preceding to the current benefit information date. (Effects that are individually significant should be separately identified.)
   1. Plan amendments
   2. Changes in the nature of the plan (for example, a plan spin-off or a merger with another plan)
   3. Changes in actuarial assumptions

i. Describe, for the current year, the effects of the following on changes in the present value of accumulated plan benefits:
   1. Increase in benefits accumulated
   2. Increase due to the passage of time
   3. Benefits paid

[*Note to auditor: Item (i) applies only if the change in actuarial information is being presented in statement format.*]

j. If an accumulated funding deficiency exists, the amount necessary to reduce the deficiency to zero under ERISA is $________

k. Have you been notified of a decision by the sponsor company to fully or partially terminate the plan? If so, please describe the effect on the plan.

l. Please describe the nature of the relationship, if any, that you may have with the plan or the sponsor company and that may appear to impair the objectivity of your work.

m. What is the amount of the unbilled and/or unpaid actuarial or other fees due your firm applicable to the plan year-end *and payable by the plan?*

n. Please supply any additional information that you believe is necessary.

Your prompt attention to this request will be appreciated.

Very truly yours,

____
Plan Administrator

Exhibit B—Illustrative Letter to Plan Actuary

In connection with their examination of our financial statements as of [*date of plan year-end*], our auditors, [*name and address*], have requested that you confirm to them the following information as of [*benefit information date*] with respect to our defined benefit pension plan described in your report dated ________________.

[*List of information to be confirmed*]

Please confirm the above information by signing the enclosed copy of this letter in the space provided, and return it directly to our auditors. If the above information is not correct, please inform our auditors directly, and, if possible, send them full details of the differences.

Your prompt attention to this request will be appreciated.

Very truly yours,

____
Plan Administrator

The above information is correct except as noted below.

____
(Date)

____
(Signature of Actuary)

Defined Contribution Plans

10.24. The net assets available for benefits for defined contribution plans are normally allocated to individual participant accounts according to procedures set forth in the plan instrument or in a collective bargaining agreement. In some cases the plan instrument may even specify the allocation of individual plan assets.

10.25. The objective of auditing procedures applied to individual participant accounts of defined contribution plans is to provide the auditor with a reasonable basis for concluding—

a. Whether net assets have been allocated to the individual participant accounts in accordance with the plan instrument.[3]

b. Whether the sum of the participant accounts reconciles with the total net assets available for plan benefits.

10.26. Procedures that the auditor ordinarily should apply to individual participant accounts include—

a. Reviewing pertinent sections of the plan instrument or collective bargaining agreement to obtain an understanding of how allocations are to be made.

b. Testing the allocation of income or loss, appreciation or depreciation in value of investments, administrative expenses, and amounts forfeited for selected accounts.

c. Testing the allocation of the employer's contribution.

d. For plans with participant contributions, determining whether individual contributions are being credited to the proper participant accounts and to the investment medium selected by the participant, if applicable.

e. Determining whether the sum of individual accounts reconciles with the total net assets available for benefits.

Depending on existing internal accounting controls and the results of other auditing procedures, the auditor may also wish to confirm contributions and other pertinent information directly with participants.

Health and Welfare Benefit Plans

10.27. Plan obligations for health and welfare benefit plans are paid out of a fund of accumulated contributions and income (a self-

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3. The effects of misallocation of assets should be considered in relation to the financial statements as a whole rather than in relation to individual accounts.

insured plan), are provided through insurance purchased by the plan from an insurance company (an insured plan), or are provided through a combination of the two. In an insured plan, liabilities for claims reported but not paid, and liabilities for claims incurred but not reported, will be paid by the insurance company and, therefore, will not appear as liabilities in the financial statements of the plan. A self-insured plan should include in its financial statements a liability for each of these claims. With regard to the plan's liabilities, the auditor should read the relevant provisions of the plan instrument and test, when appropriate, compliance with the plan instrument.

10.28. For insured plans, the auditor should determine whether the proper dollar amount of premiums has been remitted to the insurance company and whether any liability for unpaid monthly insurance premiums has been properly recorded. Monthly insurance premium payments are generally determined from the participants' eligibility records and the premium rates in the insurance contract. To test the premium payments, the auditor should—

a. Compare the number of eligible participants, as shown by the eligibility records, to the premium computation and trace the applicable premium rates to the insurance contract.

b. Trace a sample of the participants listed in the premium computation list to the eligibility records.

c. Compare monthly premiums paid and investigate the reasons for significant changes.

d. Request direct confirmation from the insurance company of the total amount of premiums paid during the year, premiums payable to the insurance company, and other liabilities and assets of the plan at year-end.

Any premium payable to the insurance company should be recorded (see paragraphs 4.14 through 4.18). The basis for the computation of this liability should be reviewed and, when possible, traced to subsequent payments. Insurance contracts should be reviewed to determine that the liability is in accordance with the contract provisions.

10.29. In self-insured plans, claims reported to the plan administrator but not paid are liabilities of the plan. A trial balance of these claims should be obtained for further testing. Individual claims should be compared with the trial balance, and the nature of the claim and the documentary support should be reviewed.

The auditor should review payments made after the date of the financial statements to determine whether all claims reported have been properly included in the trial balance. Depending on the timing of the examination, the auditor may also perform a search of open claim files.

10.30. As of the date of the statement of net assets and liabilities, there will be certain claims incurred but not yet reported to the plan, and some of these may not be reported for an extended period of time. Claims of this nature cannot be determined on an individual basis, but the aggregate amount of such claims should be subject to reasonable estimation on the basis of past loss experience and actuarial determination. If information necessary to make this estimate is not available, the auditor should consider the possible effect on his report.

10.31. The eligibility rules for many plans provide for the accumulation of eligibility credits for participants. The liability arising from eligibility credits is generally determined by applying current insurance premium rates to accumulated eligibility credits or, in the case of a self-insured plan, by applying the average cost of benefits per eligible participant. The accrued liability should be reviewed and tested for adequacy and reasonableness. Such tests should include a comparison of the employer's contributions with the participants' eligibility records, a test of the arithmetical accuracy of the accumulated credits, and a review of the overall computation of the estimated liability.

10.32. Many health and welfare benefit plans provide benefits that require an actuarial determination of the plan's liability. An actuary may also be used to determine contribution rates. If the plan requires the services of an actuary, the auditor should apply the procedures discussed in paragraphs 10.18 through 10.21 for using the work of an actuary.

10.33. The auditor should consider confirming the following types of information with the actuary:

a. A description of participant groups covered

b. A brief, general description of the characteristics of the plan used in the actuary's calculations, including, but not limited to, benefit provisions

c. The number of employees in the actuary's valuation and the number of participants and beneficiaries who are active, terminated with vested benefits, or retired under the plan *d.* The present value of accumulated claims liability under the plan (Be careful that the actuarially calculated claims liability does not include claims included elsewhere in the statement of net assets. Consider also whether all claims are properly included.)

e. The dates of (1) the valuation of the claim liability and of (2) the census data used (If the date of the census data used is other than the plan year-end, the actuary should be requested to indicate the basis for projecting the data to the year-end.)

f. Descriptions of (1) the principal assumptions and methods used in determining the present value of accumulated claims liability and of (2) any changes in assumptions or methods (for example, interest rates) and (3) the effect of any changes

g. The significant effects (either individually or in the aggregate) on the current year of the changes resulting from plan amendments

h. Knowledge of an intent on the part of the employer (sponsor company) to fully or partially terminate the plan

i. The amount of unbilled or unpaid actuary's fees applicable to the plan's year-end and payable by the plan

Chapter 11

Other Auditing Considerations

Cash

11.1. Since one of the principal activities of an employee benefit plan is to earn a return on investments, and since the plan administrator has a fiduciary responsibility to maintain plan assets in investments that earn an appropriate return, cash balances tend to be very small, representing residual amounts not invested. When cash is held in trust under a trust agreement or under an insurance contract, confirmation of the balance normally is adequate. For a plan that maintains and controls cash accounts that are independent from the trust accounts or insurance contracts, auditing procedures such as those customarily used in audits of other entities are normally appropriate.

Commitments and Contingencies

11.2. Procedures that the auditor ordinarily should apply in connection with the commitments and contingencies of an employee benefit plan include—

a. Discussing possible areas of commitments and contingencies with the sponsoring employer, trustee, or plan administrator.

b. Reviewing minutes of various committees of the plan for discussion of possible contingent liabilities or commitments.

c. Analyzing legal expenses for the period and reviewing invoices and statements from legal counsel for indications of possible contingencies. Legal expenses may be paid directly by the employer, in which case the auditor should consider reviewing those expenses.

d. Obtaining a letter from the plan's legal counsel concerning litigation, claims, assessments, and unpaid legal fees. (See SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments*, and paragraph 11.3 of this guide.)

e. Obtaining a representation letter from the plan's administrator or trustee. (See paragraph 11.10.)

11.3. The auditor should request the plan administrator to send an audit inquiry letter to those lawyers who have been consulted regarding litigation, claims, assessments, and qualification matters relating to the plan. The matters that should be covered by the audit inquiry letter are described in SAS No. 12, paragraph 9, and include a list prepared by management (or a request by management that the lawyer prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the plan in the form of legal consultation or representation. Those matters may include—

a. Breach of fiduciary responsibilities.

b. Party-in-interest transactions prohibited by ERISA.

c. Loans or leases in default and reportable to the DOL.

d. Events reportable to the PBGC.

e. Events that may jeopardize the plan's tax qualification status.

Plan Tax Status

11.4. A trust established under an employee benefit plan ordinarily is qualified under the Internal Revenue Code as exempt from federal income taxes. The objective of auditing procedures applied with respect to the tax status of a plan is to permit the auditor to conclude—

a. Whether the trust is qualified under the Internal Revenue Code as being exempt from federal income taxes and whether transactions or events have occurred that might affect the plan's qualified status.

b. Whether asserted and unasserted claims and assessments affecting plan assets resulting from the loss of tax exemption have been properly recorded or disclosed in conformity with generally accepted accounting principles.

11.5. The auditing procedures applied in an examination of a plan's tax status should include—

a. Reviewing the IRS tax determination letter or an opinion letter from the plan's qualified tax counsel. If the plan has been amended, review any new rulings issued by the IRS regarding the modified plan instrument.

b. Inquiring of the plan administrator about any plan activities that may cause it to lose its exempt status, including plan amendments or operational decisions that would violate any of the requirements described in *(c)* below.

c. Reviewing the results of auditing procedures applied in other areas of the examination and considering the findings in relation to the tax qualification requirements. The following are examples:
   1. A plan must not discriminate in favor of employees who are officers or shareholders or who are highly compensated.
   2. Benefits under the plan must not exceed the statutory limitations.
   3. Contributions to the fund must be exclusively for the benefit of participants.

Prohibited Transactions

11.6. For all employee benefit plans, transactions prohibited by ERISA can give rise to significant receivables because a plan fiduciary is liable to make good on losses to the plan resulting from a breach of fiduciary duties and to restore to the plan any profits that he made through the use of the plan's assets. (See Appendix A for a discussion of prohibited transactions.) The auditor should be alert to possible breaches of fiduciary duties or prohibited transactions and should see that they are appropriately recognized in the financial statements. The examination with respect to prohibited transactions normally should include—

a. Inquiring of company and plan officials about activities or transactions that might be prohibited.

b. Obtaining from the plan administrator a list of all parties in interest (ERISA sec. 3(14)). The auditor should also ordinarily review the administrator's procedures for identifying parties in interest and examine related documentation to determine whether the list appears to be complete.

c. Determining whether any prohibited transactions have been disclosed as a result of past IRS or other governmental examinations. Because the auditor, as a result of his regular audit work, should be familiar with significant transactions that might be prohibited, it is anticipated that few, if any, additional procedures will be necessary in most instances.

Administrative Expenses

11.7. The objective of auditing procedures applied to administrative expenses is to provide the auditor with a reasonable basis for concluding whether those expenses are in accordance with agreements, are properly approved, are properly classified, and are recorded in appropriate amounts.

11.8. The examination of administrative expenses normally should include—

a. Analyzing the account and examining supporting invoices, documents, and computations.

b. Reviewing the terms of the plan instrument and the minutes of the board of trustees or administrative committee to determine that administrative expenses were properly authorized.

c. If the plan employs a contract administrator, testing the basis of the contract payments made to determine their propriety and reasonableness.

d. If one office functions as a service organization for several plans and administrative expenses are allocated because they are not directly associated with a specific plan, reviewing the allocation to determine that it is appropriate and determining that the method of allocation selected was approved by the board of trustees or administrative committee.

e. Determining that trustee and investment adviser fees are in accordance with the respective agreements.

f. Inquiring whether the plan's administrative expenses or other transactions violate applicable laws or regulations. (See Appendix A for a discussion of "party in interest" and "reportable transactions" under ERISA.)

Subsequent Events

11.9. Guidance on the auditor's procedures relating to subsequent events is provided in SAS No. 1, sec. 560. The following auditing procedures generally should be applied for all employee benefit plans. The list is not all-inclusive and should be modified to suit the circumstances of a specific engagement.

a. Reviewing minutes of committee meetings held through the completion of field work
b. Obtaining supplemental legal representations if there is a significant period between the date of the plan's legal counsel's response and the date of completion of field work
c. Obtaining the plan's interim financial statements for a period subsequent to the audit date, if they are available, comparing them with the financial statements being examined, and investigating any unusual fluctuations
d. Inquiring of and discussing with the plan administrator or trustees—
    1. Abnormal disposal or purchase of investments since year-end.
    2. Amendments to plan and trust instruments and insurance contracts.
    3. Matters involving unusual terminations of participants, such as terminations arising from a sale of a division or layoffs.
    4. Changes in plan commitments or contingent liabilities.

Plan Representations

11.10. The auditor should obtain certain written representations from the plan trustee, administrator, or administrative agent as part of his examination (see SAS No. 19, *Client Representations*). In addition to the representations obtained under SAS No. 19, the representation letter should include, as applicable, representations regarding—

a. Whether the plan instrument has been amended.
b. Whether there were omissions from the participants' data.
    1. For example, for defined benefit pension plans: "There were no omissions from the participants' data provided the plan's actuary for the purposes of determining the actuarial present value of accumulated plan benefits and other actuarially determined amounts in the financial statements."
    2. For example, for health and welfare benefit plans that require the services of an actuary: "There were no omissions from the participants' data provided the plan's actuary for

the purpose of determining the liability for claims incurred but not reported and other actuarially determined amounts in the financial statements."

c. Whether the plan administrator agrees with the actuarial methods and assumptions used by the actuary for funding purposes and for determining accumulated plan benefits and has no knowledge or belief that would make such methods or assumptions inappropriate in the circumstances.

d. Whether there have been changes in—

1. The actuarial methods or assumptions used in calculating amounts recorded or disclosed in the financial statements.
2. Plan provisions between the actuarial valuation date and the date of this letter. [*Item (d) applies only to defined benefit plans and to those health and welfare benefit plans that require the services of an actuary.*]

e. Whether the trust established under the plan is qualified under the appropriate section of the Internal Revenue Code and intends to continue as a qualified trust.

f. Whether the plan has complied with the fidelity bonding requirements of ERISA.

g. Whether there were transactions with parties in interest (as defined in ERISA sec. 3(14) and regulations under that section) that were not disclosed in the supplemental schedules or financial statements.

h. Whether there were investments in default or considered to be uncollectible that were not disclosed in the supplemental schedules.

i. Whether there were reportable transactions (as defined in ERISA sec. 103(b)(3)(H) and regulations under that section) that were not disclosed in the supplemental schedules.

j. Whether there is a present intention to terminate the plan.

Chapter 12

The Auditor's Report

12.1. The guidance in Statements on Auditing Standards applies to an auditor's report on the financial statements of an employee benefit plan.

12.2. This chapter provides guidance on the auditor's report on the financial statements of an employee benefit plan when—

a. The auditor expresses an unqualified opinion on financial statements presented in accordance with generally accepted accounting principles (paragraphs 12.3 through 12.5).

b. Supplemental schedules relating to ERISA and DOL regulations accompany the financial statements (paragraphs 12.6 through 12.9).

c. The financial statements have been prepared on a basis of accounting other than generally accepted accounting principles (paragraphs 12.10 through 12.13).

d. The scope of the examination was limited (paragraphs 12.14 through 12.17).

e. The auditor is reporting on the financial statements of a trust established under a plan (paragraph 12.18).

f. Nonreadily marketable investments are not valued in accordance with generally accepted accounting principles (paragraphs 12.19 and 12.20).

g. The plan auditor uses the work of other auditors regarding plan investments (paragraph 12.21).

The Auditor's Standard Report

Defined Benefit Pension Plans

12.3. The following are illustrations of an auditor's report with an unqualified opinion on the financial statements of a defined benefit pension plan. In addition to the statement of net assets available for benefits and the statement of changes during the year in net assets available for benefits required by FASB Statement no. 35, the illustrations assume that information regarding the actuarial present value of accumulated plan benefits and changes therein is also presented in separate financial statements.[1]

Illustration of Auditor's Report on Financial Statements of Defined Benefit Plan Assuming End-of-Year Benefit Information Date

To the Board of Trustees of
XYZ Pension Plan:

We have examined the statements of net assets available for benefits and of accumulated plan benefits of XYZ Pension Plan as of December 31, 19X2, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial status of the Plan as of December 31, 19X2, and the changes in its financial status for the year then ended in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.[2]

(Firm Name)

(Date)

1. FASB Statement no. 35 permits variation in the presentation of information regarding the actuarial present value of accumulated plan benefits and changes therein. If such information is not presented in separate financial statements but is presented on the face of one or more financial statements or the notes thereto, the scope paragraph of the auditor's report should refer only to the financial statements that are presented. For example, if information regarding accumulated plan benefits and changes therein is presented in the notes to the financial statements regarding net assets available for benefits and changes therein, the first sentence of the auditor's report might read as follows:

> We have examined the statement of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2, and the related statement of changes in net assets available for benefits for the year then ended.

The wording of the opinion paragraph would be the same as in the illustration and would refer to the financial status of the plan.

2. APB Statement no. 4, paragraph 133 states, "The financial position of an enterprise at a particular time comprises its assets, liabilities, and owners' equity and the relationship among them. . . ." FASB Statement no. 35 left unresolved the question of whether accumulated plan benefit information represents a liability of a defined benefit pension plan. Accordingly, since the financial statements

Illustration of Auditor's Report on Financial Statements of Defined Benefit Plan Assuming Beginning-of-Year Benefit Information Date

To the Board of Trustees of
XYZ Pension Plan:

We have examined the statements of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statements of changes in net assets available for benefits for the years then ended and the statement of accumulated plan benefits as of December 31, 19X1, and the related statement of changes in accumulated plan benefits for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial status of the Plan as of December 31, 19X1, and changes in its financial status for the year then ended and information regarding net assets available for benefits and changes therein as of and for the year ended December 31, 19X2, in conformity with generally accepted accounting principles applied on a consistent basis.

____
(Firm Name)

____
(Date)

Defined Contribution Plans

12.4. The following is an illustration of an auditor's report with an unqualified opinion on the financial statements of a profit-sharing plan.

To the Board of Trustees of
XYZ Company Profit-Sharing Plan:

We have examined the statement of net assets available for plan benefits of XYZ Company Profit-Sharing Plan as of December 31, 19X1, and the related statement of changes in net assets available for plan benefits for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such

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of a defined benefit pension plan do not present information on accumulated plan benefits as a liability of the plan, and since they do not present an account comparable to the owners' equity of other types of entities, the auditor's opinion in the illustrative reports does not refer to the presentation of the financial position of the plan. The terms "financial status" and "changes in financial status," as used here, refer to the presentation of information regarding net assets available for plan benefits and changes therein and information regarding accumulated plan benefits and changes therein as specified in FASB Statement no. 35 (see FASB Statement no. 35, paragraph 235).

other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the net assets available for plan benefits of the Plan as of December 31, 19X1, and changes in net assets available for plan benefits for the year then ended in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(Firm Name)

(Date)

Health and Welfare Benefit Plans

12.5. The following is an illustration of an auditor's report with an unqualified opinion on the financial statements of an employee health and welfare benefit plan.

To the Board of Trustees of
Bizco Corporation Employee Health
and Welfare Benefit Plan:

We have examined the statement of net assets of Bizco Corporation Employee Health and Welfare Benefit Plan as of December 31, 19X1, and the related statement of changes in net assets for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the net assets of the Plan as of December 31, 19X1, and changes in net assets for the year then ended in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(Firm Name)

(Date)

Supplemental Schedules Relating to ERISA and DOL Regulations

12.6. Besides the financial statements and related disclosures, which may conform to the requirements of FASB Statement no. 35, ERISA and DOL regulations require additional information to be disclosed. Some of this information is required to be covered by the auditor's report, but other required additional information need not be covered by the auditor's report. (The information required by ERISA and by the regulations is described in Appendix A.)

12.7. SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, provides guidance on the form and content of reporting when the auditor submits to his client or others a document containing information accompanying the basic financial statements. Paragraph 6 of SAS No. 29 provides the following guidelines for the auditor's report in those circumstances:

a. The report should state that the examination has been made for the purpose of forming an opinion on the basic financial statements taken as a whole.

b. The report should identify the accompanying information. (Identification may be made by descriptive title or page number of the document.)

c. The report should state that the accompanying information is presented for purposes of additional analysis and is not a required part of the basic financial statements. The report may refer to regulatory agency requirements applicable to the information.

d. The report should include either an opinion on whether the accompanying information is fairly stated in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion, depending on whether the information has been subjected to the auditing procedures applied in the examination of the basic financial statements. The auditor may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder.

e. The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or appear separately in the auditor-submitted document.

12.8. When the auditor's report covers additional information and he has applied auditing procedures and is expressing an opinion on the additional information, a separate paragraph of the report might be worded as follows:

> Our examination was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for purposes of complying with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 and are not a required part of the basic financial statements. The supplemental schedules have been subjected to the auditing procedures applied in the examination of the basic financial state-

ments and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

When additional information is presented on which the auditor does not express an opinion, the information should be marked as unaudited or should refer to the auditor's disclaimer of opinion, and the last sentence of the example paragraph above should state the following:

> The supplemental schedules have not been subjected to the auditing procedures applied in the examination of the basic financial statements, and, accordingly, we express no opinion on them.

12.9. In an examination in accordance with generally accepted auditing standards, the report need not state that the financial statements and schedules comply with the DOL filing requirements. During his examination, however, the auditor may become aware of departures from such requirements that are not also departures from generally accepted accounting principles, in which case he may wish to emphasize the matter in an explanatory paragraph of his report.

Non-GAAP-Basis Financial Statements

12.10. Present DOL regulations permit, but do not require, financial statements included in the annual report (Form 5500) to be prepared on a basis of accounting other than generally accepted accounting principles. Also, they do not prohibit variances from generally accepted accounting principles if the variances are described in a note to the financial statements.

12.11. A common example of the use of a basis other than generally accepted accounting principles is financial statements prepared on the modified cash basis of accounting for filing with the DOL. SAS No. 14, paragraphs 2 through 8, provides guidance on "Reports on Financial Statements Prepared in Accordance With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles." Included in the definition of a "comprehensive basis of accounting" are the cash basis and modifications thereof having substantial support. Cash basis financial statements that adjust securities investments to fair value are considered to be prepared on a modified cash basis of accounting.

12.12. The following is an illustration of an auditor's report on the financial statements of a defined benefit pension plan prepared on the modified cash basis. The illustration assumes that information on accumulated plan benefits is included in the notes to the financial statements.

To the Board of Trustees of
XYZ Pension Plan:

We have examined the statements of net assets available for plan benefits (modified cash basis) of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for plan benefits (modified cash basis) for the year ended December 31, 19X2. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described in Note X, the Plan's policy is to prepare its financial statements and supplemental schedules on a modified cash basis of accounting, which differs from generally accepted accounting principles. Accordingly, the accompanying financial statements and schedules are not intended to be presented in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly the financial status of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the changes in its financial status for the year ended December 31, 19X2, on the basis of accounting described in Note X, which basis has been applied in a consistent manner.

Our examinations were made for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules (modified cash basis) of (1) assets held for investment, (2) transactions in excess of 3 percent of the current value of plan assets, and (3) investments in loans and fixed income obligations in default or classified as uncollectible as of or for the year ended December 31, 19X2, are presented for purposes of complying with the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 and are not a required part of the basic financial statements. The supplemental schedules have been subjected to the auditing procedures applied in the examinations of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

(Firm Name)

(Date)

12.13. If the plan administrator prepares financial statements on a modified cash basis or other basis not in conformity with generally accepted accounting principles, he might decide not to disclose information regarding accumulated plan benefits. In such cases, the auditor should comment in his report on the lack of such disclosure and should express a qualified or an adverse opinion. (See SAS No. 2, paragraph 17, and the auditing interpretation of SAS No. 14, "Adequacy of Disclosure in Financial Statements Prepared on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles" [February 1980].)

Limited-Scope Examinations Under DOL Regulations

12.14. Under DOL regulations the plan auditor need not examine and report on information prepared by banks, similar institutions, or insurance carriers that are regulated, supervised, and subject to periodic examination by a state or federal agency if that information is certified as complete and accurate by the bank, similar institution, or insurance carrier (see Appendix A). Thus the plan administrator may restrict the auditor's examination of the assets held and transactions executed by such institutions.[3] The following is an example of the auditor's report in these special circumstances when he believes this to be a significant limitation on the scope of his examination.[4]

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3. Certain data furnished and certified by a bank, similar institution, or an insurance carrier are based on information supplied by the plan administrator. Accordingly, the auditor should satisfy himself that the amounts reported by the trustee as being received from, and disbursed at the direction of, the plan administrator or other authorized party have been properly determined in accordance with the terms of the plan and that the information included in the financial statements and schedules has been presented in compliance with the DOL Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. If the auditor is precluded from performing these procedures, it will ordinarily be necessary for him to disclaim an opinion on the financial statements in accordance with SAS No. 2, paragraphs 45 through 47 because of the limitation on the scope of his examination, and it would not be appropriate for him to comment on whether the financial statements are presented in compliance with ERISA and applicable DOL regulations.
4. If the plan's financial statements are also not in conformity with generally accepted accounting principles, the auditor's report should also include a paragraph describing the departure. Paragraph 12.12 provides an illustration of the wording of such a paragraph.

To the Board of Trustees
of XYZ Pension Plan:

We have examined the financial statements and schedules of XYZ Pension Plan as of December 31, 19X1, and for the year then ended, as listed in the accompanying index. Except as stated in the following paragraph, our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As permitted by Section 2520.103-8 of the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee of the Plan, except for comparing the information with the related information included in the 19X1 financial statements and supplemental schedules. We have been informed by the plan administrator that the trustee holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee as of and for the year ended December 31, 19X1, that the information provided to the plan administrator by the trustee is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the trustee, have been examined by us and, in our opinion, are presented in compliance with the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

(Firm Name)

(Date)

Limited-Scope Examination in Prior Year

12.15. An employee benefit plan administrator may elect not to limit the scope of the examination in the current year although the scope of the examination in the prior year was limited in accordance with DOL regulations.[5] The following illustrates a report

5. Present DOL regulations prescribe that the annual report include a statement of net assets available for benefits on a comparative basis; the statement of changes in net assets available for benefits is required for the current year only.

on comparative financial statements of a defined benefit pension plan under those circumstances.

To the Board of Trustees
of XYZ Pension Plan:

We have examined the statements of net assets available for plan benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for plan benefits for the year ended December 31, 19X2 and the statements of accumulated plan benefits as of December 31, 19X2 and 19X1, and the related statement of changes in accumulated plan benefits for the year ended December 31, 19X2. Except as explained in the following paragraph, our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As permitted by Section 2520.103-8 of the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, investment assets held by ABC Bank, the trustee of the Plan, and transactions in those assets were excluded from the scope of our examination of the Plan's 19X1 financial statements, except for comparing the information provided by the trustee, which is summarized in Note X, with the related information included in the financial statements.

Because of the signficance of the information that we did not audit, we are unable to, and do not, express an opinion on the Plan's financial statements as of and for the year ended December 31, 19X1. The form and content of the information included in the 19X1 financial statements, other than that derived from the information certified by the trustee, have been examined by us and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

In our opinion, the financial statements, referred to above, of XYZ Pension Plan as of December 31, 19X2, and for the year then ended present fairly the financial status of XYZ Pension Plan as of December 31, 19X2, and changes in its financial status for the year then ended in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Our examinations were made for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of (1) assets held for investment, (2) transactions in excess of 3 percent of the current value of plan assets, and (3) investments in loans and fixed income obligations in default or classified as uncollectible as of or for the year ended December 31, 19X2, are presented for purposes of complying with the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 and are not a required part of the basic financial statements. The supplemental schedules have been subjected to the auditing procedures applied in the examination of the basic financial statements for the year ended December 31, 19X2, and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

(Firm Name)

(Date)

Limited-Scope Examination in Current Year

12.16. A plan may exclude from the auditor's examination its assets held by banks or insurance companies in the current year, whereas the scope of the examination in the prior year was unrestricted. When comparative financial statements will be issued in those circumstances, the auditor should report on the prior year's financial statements of the plan in accordance with SAS No. 15, paragraph 2. Although that section states that the auditor's report should ordinarily be dated as of the completion of the most recent examination, the procedures performed in an examination that has been restricted, as permitted by section 2520.103-8 of the DOL's rules and regulations for reporting and disclosure, generally are not sufficient to enable the auditor to update his report on the prior year's financial statements. Accordingly, the auditor should consider referring to the date of his previously issued report on the prior year's financial statements in expressing his opinion on that information. The following illustrates a report on comparative financial statements in those circumstances.[6]

To the Board of Trustees of
XYZ Pension Plan:

We have examined the statements of net assets available for plan benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for plan benefits for the year ended December 31, 19X2, and the supplemental schedules of (1) assets held for investment, (2) transactions in excess of 3 percent of the current value of plan assets, and (3) investments in loans and fixed income obligations in default or classified as uncollectible as of or for the year ended December 31, 19X2.

6. This illustration assumes that information regarding accumulated plan benefits and changes therein is included in the notes to the financial statements of net assets available for plan benefits and changes in net assets available for plan benefits.

Except as explained in the following paragraph with respect to the 19X2 financial statements and supplemental schedules, our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such test of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As permitted by Section 2520.103-8 of the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee of the Plan, except for comparing the information with the related information included in the 19X2 financial statements and the supplemental schedules. We have been informed by the plan administrator that the trustee holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee as of and for the year ended December 31, 19X2, that the information provided to the plan administrator by the trustee is complete and accurate.

Because of the significance of the information in the Plan's 19X2 financial statements that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules as of or for the year ended December 31, 19X2. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the information certified by the trustee, has been examined by us and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

In our report dated May 20, 19X2, we expressed our opinion that the statement of net assets available for plan benefits of XYZ Pension Plan as of December 31, 19X1, presents fairly the financial status of XYZ Pension Plan as of December 31, 19X1, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(Firm Name)

April 1, 19X3

Limited-Scope Examination for Multiemployer Pension Plan

12.17. The following is an example of the auditor's report disclaiming an opinion on the financial statements of a multiemployer pension plan when the auditor has been unable to apply all the procedures he considers necessary with regard to participants' data maintained by the sponsor companies.

To the Board of Trustees of
XYZ Multiemployer Pension Plan:

We have examined the statements of [*identify*] of XYZ Multiemployer Pension Plan as of December 31, 19X2 and 19X1, and for the years then ended. Except as explained in the following paragraph, our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The Plan's records and procedures are not adequate to assure the completeness of participants' data on which contributions and benefit payments are determined, and the Board of Trustees did not engage us to perform, and we did not perform, any other auditing procedures with respect to participants' data maintained by the sponsor companies or individual participants.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements.

(Firm Name)

(Date)

Reporting on the Financial Statements of a Trust Established Under a Plan

12.18. Under both FASB Statement no. 35 and ERISA, the reporting entity is the employee benefit plan. However, the plan administrator may engage an independent auditor to report on the financial statements of a trust established under the plan. In such examinations, the auditor should observe the applicable provisions of this guide. Users of the financial statements of the trust may not be aware of the distinction between the trust and the plan. Therefore, when reporting on such a trust, the auditor's report should explain that the financial statements of the trust do not purport to present the financial status or changes in financial status of the plan in accordance with generally accepted accounting principles and that the financial statements do not purport to satisfy the DOL reporting and disclosure requirements. The following is an example of the auditor's report on the financial statements of a trust established under an employee benefit plan.

To the Board of Trustees
of ABC Pension Trust:

We have examined the statement of net assets of ABC Pension Trust as of December 31, 19X2, and the related statement of changes in net assets and trust balance for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The accompanying statements are those of ABC Pension Trust, which is established under XYZ Pension Plan; the statements do not purport to present the financial status of XYZ Pension Plan. The statements do not contain certain information on accumulated plan benefits and other disclosures necessary for a fair presentation of the financial status of XYZ Pension Plan in conformity with generally accepted accounting principles. Furthermore, these statements do not purport to satisfy the Department of Labor reporting and disclosure requirements relating to the financial statements of employee benefit plans.

In our opinion, the financial statements referred to above present fairly the net assets of ABC Pension Trust as of December 31, 19X2, and the changes in its net assets and trust balance for the year then ended in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(Firm Name)

(Date)

Nonreadily Marketable Investments—Departure from GAAP

12.19. ERISA defines current value as "fair market value where available and otherwise the fair value as determined in good faith by a trustee or a named fiduciary." Investments for which fair market value may not be readily determinable include securities that are not readily marketable, private debt placements, and real estate investments (see paragraphs 2.6 through 2.8).

12.20. If the auditor's examination discloses that the valuation procedures followed by the plan are inadequate or unreasonable, or if the underlying documentation does not appear to support the valuation, the auditor should qualify his opinion because of the departure from generally accepted accounting principles. Accordingly, an "except for" or adverse opinion would be appropriate. The following illustration provides an example of the explanatory paragraph and opinion paragraph of an auditor's report qualified because of inadequate procedures to value investments. The illustration assumes that the auditor cannot reasonably determine the effects of the departure.

To the Board of Trustees of
XYZ Pension Plan:

We have examined the statements of net assets available for benefits and of accumulated plan benefits of XYZ Pension Plan as of December 31, 19X2, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As discussed in Note X, investments amounting to $______ (_____ percent of net assets available for benefits) as of December 31, 19X2, have been valued at estimated fair value as determined by the Board of Trustees. We have reviewed the procedures applied by the trustees in valuing the securities and have inspected the underlying documentation. In our opinion, those procedures are not adequate to determine the fair value of the investments in conformity with generally accepted accounting principles. The effect on the financial statements and supplemental schedules of not applying adequate procedures to determine the fair value of the securities is not determinable.

In our opinion, except for the effects on the financial statements of the procedures used by the Board of Trustees to determine the valuation of investments, as described in the preceding paragraph, the financial statements referred to above present fairly the financial status of XYZ Pension Plan as of December 31, 19X2, and the changes in its financial status for the year then ended in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Our examination was made for the purpose of forming an opinion on the financial statements taken as a whole. The additional information presented in supplemental schedules of (1) assets held for investment, (2) transactions in excess of 3 percent of the current value of plan assets, and (3) investments in loans and fixed income obligations in default or classified as uncollectible as of or for the year ended December 31, 19X2, is presented for purposes of complying with the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 and is not a required part of the basic financial statements. That additional information has been subjected to the auditing procedures applied in the examination of the basic financial statements for the year ended December 31, 19X2; and in our opinion, except for the effects, if any, of the valuation of investments, as described above, the additional information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

(Firm Name)

(Date)

Reference to the Work of Other Auditors Regarding Plan Investments

12.21. Throughout this guide, circumstances are discussed in which the plan auditor may use the work of another auditor regarding plan investments. For example, the plan auditor may use the report of the independent auditor of the financial statements of a common or commingled trust fund or a separate account to obtain assurance regarding significant amounts of the plan's assets, and he may use a special-purpose report on a third party's system of internal accounting control relating to significant amounts of the plan's assets. Although the amount of the plan's assets covered by the other auditor's report or relating to the internal accounting controls covered by the special-purpose report may be material in relation to the net assets of the plan, the plan auditor ordinarily would be the principal auditor. The work of the other auditor is used by the plan auditor as competent evidential matter regarding the value of certain investments or internal accounting controls relating to plan investments. Since the plan auditor performs procedures with respect to investments, contributions, benefit payments, plan obligations, participants' data, and other elements of the financial statements, the plan auditor is ordinarily the only auditor in a position to express an opinion on the plan's financial statements taken as a whole. The plan auditor may use reports by other auditors in the examination of the plan's financial statements, but the other auditors are not responsible for examining a portion of the plan's financial statements as of any specific date or for any specific period. Thus, there cannot be a meaningful indication of a division of responsibility for the plan's financial statements. Therefore, the plan auditor ordinarily should not refer to the other auditors in his report.

Appendix A

ERISA and Related Regulations

A.1. The following description is intended to enable the auditor to familiarize himself with some of the more important provisions of the Employee Retirement Income Securities Act of 1974 (ERISA). This summary is not intended to serve as a substitute for the entire act or for the advice of legal counsel. Changes in the statute and related regulations subsequent to publication of this guide also should be considered.

A.2. The primary purpose of ERISA is to protect the interests of workers who participate in employee benefit plans and their beneficiaries. ERISA seeks to attain that objective by requiring financial reporting to government agencies and disclosure to participants and beneficiaries, by establishing standards of conduct for plan fiduciaries, and by providing appropriate remedies, sanctions, and access to the federal courts. Another objective of ERISA is to improve the soundness of employee benefit plans by requiring plans (*a*) to vest the accrued benefits of employees with significant periods of service, (*b*) to meet minimum standards of funding, and (*c*) with respect to defined benefit pension plans, to subscribe to plan termination insurance through the Pension Benefit Guaranty Corporation (PBGC).

A.3. ERISA was designed to replace all provisions of the Welfare and Pension Plans Disclosure Act of 1958, based on implementation in various phases through 1984. ERISA amended certain sections of the Internal Revenue Code and generally preempted state laws that related to employee benefit plans.

Coverage

A.4. ERISA generally applies to employee benefit plans that are qualified under the revenue code or established or maintained by plan sponsors engaged in interstate commerce or in any industry or activity affecting interstate commerce. Most aspects of ERISA do not apply to—

a. Governmental plans, including those of state and local governments.
b. Church plans unless the plan has made a voluntary election to be covered.
c. Plans established and maintained solely for the purpose of complying with applicable workers' compensation, unemployment compensation, or disability insurance laws.
d. Plans maintained outside the United States primarily for nonresident aliens.
e. Unfunded excess benefit plans.

Certain of the foregoing plans, if "qualified" under the IRC, are required to file annual reports with the IRS. For example, certain governmental plans and church plans are required to file Form 5500 series reports.

Participation Standards (ERISA sec. 202)

A.5. ERISA generally provides that a pension plan cannot exclude an employee from participation because of age or service if he has completed one year of service and is at least twenty-five years old.[1] However, a pension plan may defer participation until attainment of age twenty-five and three years of service, provided that benefits vest 100 percent thereafter. In addition, ERISA provides that an individual may not be denied the right to participate in a defined benefit pension plan or a target-benefit pension plan on the basis of having attained a specified age unless he is first employed by the plan sponsor within five years of the normal retirement age under the plan.

Vesting Standards (ERISA sec. 203)

A.6. Pension plan participants' rights to accrued benefits from their own contributions are nonforfeitable. In addition, pension plans must provide that employees' rights to accrued benefits from employer contributions vest in a manner that equals or exceeds any one of three alternative schedules:

a. Graded vesting of accrued benefits, with at least 25 percent vesting after five years of service, at least 5 percent each year thereafter for five years, and 10 percent each year after that, so that the employee's accrued benefit would be 100 percent vested after fifteen years.

b. One hundred percent vesting of accrued benefits after ten years of service, with no vesting required before the end of the ten-year period.

c. A "rule of 45," under which accrued benefits of an employee with five or more years of service must be at least 50 percent vested when the sum of his age and service equals 45, with 10 percent additional vesting for each year of service thereafter, provided that a participant with ten years of service must be at least 50 percent vested and an additional 10 percent must vest for each additional year of service. Under the "rule of 45," years of service completed by a participant before the age of twenty-two must be considered (unless the person was not a plan participant before age twenty-two).

A.7. A special minimum vesting schedule applies to certain defined contribution plans referred to as "class-year plans." Those plans must provide 100 percent vesting of benefits derived from employer contributions within five years after the end of the plan year for which any contribution was made.

A.8. In some instances the IRS may require more stringent vesting standards, particularly if it believes that the vesting schedule of a plan tends to favor highly compensated employees or officials of a company (IRC sec. 411(d)). In those instances the IRS may require more rapid

1. Pension plans are broadly defined in ERISA to include both defined benefit and defined contribution plans.

vesting; for example, 40 percent vesting after four years of service, 5 percent vesting for each of the next two years, and 10 percent vesting for each of the next five years, resulting in 100 percent vesting after eleven years of service (Rev. Procs. 75-49 and 76-1). (Various proposals have suggested stricter vesting standards for certain plans.)

A.9. For computation of years of service as they relate to an employee's vesting rights, a year is defined in ERISA as a twelve-month period during which the participant has completed at least 1,000 hours of service (ERISA sec. 203(b)(2)). Regulations that refine that definition are complex. In addition, special provisions are made for a participant's breaks in service.

A.10. Sufficient records must be maintained to determine an employee's benefits. ERISA sec. 105 requires that the plan administrator, on request, furnish to participants and beneficiaries under the plan the latest information available about their total benefits accrued and the nonforfeitable benefits, if any, that have accrued or the earliest date on which benefits will become nonforfeitable.

Minimum Funding Standards (ERISA secs. 301 through 306)

A.11. ERISA requires that plans subject to the minimum funding standards maintain an account called the "funding standard account" (FSA). This account is a memorandum account maintained for tax qualification purposes, and it is not included in the plan's financial statements. Defined benefit pension plans are required to maintain an FSA. Certain defined contribution plans (that is, money-purchase and target-benefit plans) must maintain FSAs, but on a more limited basis. The FSA is used to determine compliance with minimum funding standards set forth in ERISA.

A.12. For most defined benefit plans, the sponsor's annual contribution to the plan must be sufficient to cover the normal cost for the period, annual interest on unfunded amounts, amortization of past service liability, increases or decreases in past service liability resulting from plan amendments, and experience gains or losses and actuarial gains or losses from changes in actuarial assumptions.

A.13. An accumulated funding deficiency is the excess of total charges (required contributions) to the FSA for all plan years (beginning with the first plan year when the funding standards are applicable) over total credits (actual contributions) to the account for those years. Accumulated funding deficiencies, in the absence of a waiver, may result in an excise tax payable by the plan sponsor for failure to meet the minimum funding standards and in possible action by the IRS to enforce the standards. If there is a deficiency in the FSA at the end of the plan year, the auditor should consider whether a receivable from the employer company should be reflected in the plan's financial statements. (See chapter 8 for a discussion of contributions receivable.)

A.14. The secretary of the Treasury may waive all or part of the minimum funding requirements for a plan year in which the minimum funding standard cannot be met without imposing substantial business hardship on the employer. That waiver is issued, however, only if failure to do so would be adverse to the participants' interests. The secretary determines whether a substantial hardship would occur on the basis of various factors, certain of which are stated in ERISA (sec. 303). This may not necessarily eliminate the plan's need to record a contribution receivable (see paragraph 2.11).

Reporting and Disclosure (ERISA secs. 101 through 111 and 1031 through 1034)

A.15. ERISA requires that various reports be prepared and filed with the IRS and that others be furnished to plan participants and beneficiaries, the DOL, and the PBGC. The plan administrator is required to file with the DOL an initial plan description and summary of the description, supplemented by amended descriptions. Most plans must file an annual report that includes financial statements and schedules, an actuarial statement (for defined benefit pension plans) certified by an enrolled actuary, and other information with the IRS, which provides a copy to the DOL.

A.16. Participants and beneficiaries are to receive the summary plan description and a summary annual report from the plan. Participants and beneficiaries are entitled, under ERISA sec. 105, to receive on request a statement containing certain benefit information.

Annual Report

A.17. The report of most significance to the auditor is the annual report. Generally, plans with 100 or more participants at the beginning of the plan year must file an annual report (Form 5500) containing, with certain exceptions (see paragraphs A.27 and A.28), financial statements, separate schedules, notes required for a full and fair presentation, and an independent public accountant's report.

A.18. To avoid "duplicative" reporting and disclosure requirements of ERISA, and to "provide a clearer portrayal of the financial activity and status of employee benefit plans," the DOL has issued regulations (regs. sec. 2520.103-1) that permit a limited exemption for health and welfare plans and an alternative method of compliance for pension plans. As a result, plan administrators have the option of filing their annual reports either under the provisions of ERISA sec. 103 and certain other regulations or under the limited exemption and alternative method described in the regulations. Although the requirements of the alternative method of compliance are clearer than those of ERISA, the requirements of both filing methods are similar in scope, and some plans still file under the provisions of ERISA.

A.19. Financial statements required under both methods are, for pension plans, a statement of assets and liabilities and a statement of changes in net assets available for plan benefits; and for health and welfare plans, a statement of assets and liabilities, a statement of changes in fund balance, and a statement of changes in financial position. The defined benefit pension plan financial statements required by FASB Statement no. 35 are acceptable to the DOL. Notes to the financial statements that should be "considered" under ERISA but "shall" be included under the alternative method are—

a. A description of the plan, including significant changes in the plan and the effect of the changes on benefits.
b. The funding policy and changes in funding policy (for pension plans only).
c. A description of material lease commitments and other commitments and contingent liabilities.
d. A description of any agreements and transactions with persons known to be parties in interest.[2]
e. A general description of priorities in the event of plan termination.
f. Whether or not a tax ruling or determination letter has been obtained.
g. Any other information required for a fair presentation.

A.20. The limited exemption or alternative method also calls for a description of accounting principles and variances from generally accepted accounting principles and an explanation of any differences between the separate financial statements and the financial information required on Form 5500. The regulations require separate schedules of—

a. Investment assets (one schedule of assets held at plan year-end and one schedule of certain assets acquired and disposed of within the plan year), showing both cost and fair value or sales proceeds.
b. Transactions with parties in interest (excluding any transactions exempted from prohibited transaction rules).
c. Loans on fixed income obligations in default or uncollectible.
d. Leases in default or uncollectible.
e. Reportable transactions.

The reportable transactions schedule should include transactions that exceed 3 percent of the fair value of plan assets at the beginning of the year. Regs. sec. 2520.103-6 defines several types of reportable transactions, including certain series of transactions that need to be reported.

2. The exemption from the requirement to report party-in-interest transactions that are exempt from the prohibited transactions rules does not apply here (see paragraph A.20b).

A.21. If the plan elects to file under ERISA, two additional schedules must be included:

a. Assets and liabilities by category, in comparative form
b. Receipts and disbursements, by source or application

Filing Under ERISA vs. the Limited Exemption or Alternative Method of Compliance

A.22. In addition to those differences described above, the limited exemption or alternative method of compliance (referred to in this guide as the "alternative method") differs from the requirements of ERISA in several ways. ERISA requires the auditor to express an opinion on whether the financial statements conform with generally accepted accounting principles. ERISA and the alternative method require the auditor to state whether the examination was conducted in accordance with generally accepted auditing standards. The alternative method also requires the auditor's report to disclose any omitted procedures and the reasons for their omission, to identify whether changes in accounting principles are the result of DOL rules, and to comply with other requirements.[3] Another difference is that under ERISA the schedules of assets and liabilities and of receipts and disbursements need to be covered by the auditor's report, whereas under the alternative method those items need not be covered unless they are intended to serve as the required financial statements. Under the alternative method, the statement of assets and liabilities is to be presented at fair value and in comparative form, showing the prior year's figures. ERISA is silent about the valuation method and requires data only for the current year.

Filings for Group Insurance Arrangements

A.23. If a trust or other entity is the holder of insurance contracts under a group health and welfare benefits insurance arrangement, and if that trust or other entity files an annual report (Form 5500) with the DOL, the individual health and welfare plans need not file annual reports. To relieve the individual plans of the responsibility for filing annual reports under ERISA or the limited exemption, the trust or other entity must file an annual report containing the information described in paragraphs A.19 (excluding subparagraph *f*) and A.20, as well as the information described in paragraph A.24.

3. The other requirements are that the report be dated and manually signed, that it indicate the city and state where it is issued, and that it identify (without necessarily enumerating) the statements and schedules covered.

Investments in Common or Commingled Trust Funds or Pooled Separate Accounts (regs. secs. 2520.103-3, -4, and -9)

A.24. If a plan has assets invested in a common or commingled trust fund or in a pooled separate account maintained by a bank, a similar institution, or an insurance carrier (which is regulated, supervised, and subject to periodic examination by a state or federal agency), then the plan's financial statements need not include any information regarding individual transactions of the fund or account. Required information may be reflected in terms of units of participation in that fund or account. The annual report of a plan with those investments is required to include a statement of assets and liabilities of the common or commingled trust fund or pooled separate account for the fiscal year of the fund or account that ends within the plan year for which the annual report is filed. When the bank or insurance company files those financial statements directly with the DOL (and meets certain requirements), the plan's annual report is required to include the employer identification number of the fund or account and a certification that the plan has received a copy of that financial statement.

A.25. The explanation to the regulations states that the annual reporting exemption outlined above does not apply to situations in which assets of more than one plan maintained by a single employer or by members of a controlled group of corporations are held in a single fund by a bank (referred to as a "master trust").

Information Certified by a Bank or Insurance Company

A.26. Regulations concerning annual report filings state that a plan whose assets are held by a bank, a similar institution, or an insurance carrier (as described in paragraph A.24) is not required to have its auditor extend his examination to any statements or information prepared and certified by that institution (regs. sec. 2520.103-8).[4] A plan may elect to restrict the scope of the auditor's examination in this manner regardless of the method of filing. (See paragraphs 1.14 and 12.14 through 12.16 for a discussion of the auditor's responsibilities when the scope of the examination is so restricted.)

4. This limitation on the scope of an auditor's examination applies to plans sponsored by a "regulated" bank or insurance carrier for its own employees, as well as to plans of unrelated parties.

Exceptions

A.27. Generally, plans with fewer than 100 participants at the beginning of the plan year need not engage an independent public accountant to examine and report on financial information (regs. sec. 2520.104-46). Such plans file Form 5500-C. Keogh plans with fewer than 100 participants and at least one owner-employee participant file Form 5500-K (regs. sec. 2520.104-41).

A.28. Certain insured plans are exempt from some reporting and disclosure requirements. For example, a pension plan need not file financial statements and separate schedules or engage an independent public accountant to perform an audit if it is funded exclusively through allocated insurance contracts, if benefits are fully guaranteed by the insurance company, if the premiums are paid directly by the employer or employee organization from its general assets, and if other conditions are met. Those plans, however, must still file Form 5500 (regs. sec. 2520.104-44). Plans funded through unallocated contracts, such as deposit administration (DA) and immediate participation guarantee (IPG) contracts, are not exempt from the audit requirement. (See chapter 7 for a discussion of those types of contracts.)

Fiduciary Responsibilities (ERISA secs. 401 through 414)

A.29. ERISA establishes standards for plan investments and transactions and imposes restrictions and responsibilities on plan fiduciaries.

A.30. A fiduciary's responsibilities include managing plan assets solely in the interest of participants and beneficiaries (with the care a prudent man would exercise) and diversifying investments in order to minimize the risk of large losses unless it is clearly not prudent to do so (ERISA sec. 404). Most plans are required to have no more than 10 percent of the fair market value of the plan assets invested in a combination of "qualifying employer securities" and "qualifying employer real property" (see ERISA sec. 407, and related DOL regulations for the ten-year phase-in rules).

A.31. A plan fiduciary is prohibited from causing the plan to engage in certain transactions with a party in interest (ERISA sec. 406).[5] The following transactions between a plan and a party in interest are generally prohibited (ERISA sec. 406):

a. A sale, exchange, or lease of property, except to the extent allowed
b. A loan or other extension of credit
c. The furnishing of goods, services, or facilities, except as allowed under the act

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5. ERISA defines a party in interest generally as any fiduciary or employee of the plan, any person who provides services to the plan, an employer whose employees are covered by the plan, an employee association whose members are covered by the plan, a person who owns 50 percent or more of such an employer or employee association, or relatives of a person described above.

d. A transfer of plan assets to a party in interest for the use or benefit of a party in interest
e. An acquisition of employer securities or real property, except to the extent allowed

A.32. A fiduciary is also generally prohibited from using the plan assets for his own interest or his own account, acting in any plan transactions on behalf of a party whose interests are adverse to those of the plan or its participants, and receiving consideration for his own account from a party dealing with the plan in connection with a transaction involving the plan assets.

A.33. ERISA sec. 408 allows specific exceptions to the rules on prohibited transactions, and the secretaries of the Department of Labor and the Treasury have granted special exemptions from the rules. For example, ERISA specifies that a fiduciary may receive reasonable compensation from a plan for his services (unless he is a full-time employee of the sponsoring employer or employee organization), reasonable benefits as a plan participant, and reimbursement for expenses. Other exceptions are described in ERISA, regulations, and rulings. Advice of legal counsel should be obtained when investigating a possible prohibited transaction or other breach of fiduciary duties.

A.34. A fiduciary must make good any losses to the plan resulting from a breach of fiduciary duty and must return to the plan any profits he made through the use of plan assets (ERISA sec. 409).

Plan Termination Insurance

A.35. The insurance provisions provided under Title IV of ERISA (as amended by the Multiemployer Pension Plan Amendment Act of 1980) generally apply only to qualified pension plans but not to most defined contribution plans (ERISA sec. 4021).

A.36. In order to fund the activities of the PBGC, plan administrators are required to make annual premium payments based on the number of participants in the plan. Annual premium levels are revised periodically based on PBGC experience (ERISA sec. 4006).

A.37. Special requirements for reporting to the PBGC apply when a plan intends to terminate its activities (ERISA sec. 4041) or when a "reportable event" occurs (ERISA sec. 4043). When a plan is terminated, the sponsor may be liable to the PBGC for any or all payments made by the PBGC.

Administration and Enforcement (ERISA secs. 501 through 514)

A.38. Responsibility for administration of ERISA and enforcement of its provisions rests jointly with the IRS and the DOL. Both agencies are empowered to bring suit in federal court in civil or criminal actions.

A.39. Failure to meet ERISA's requirements can result in the imposition of substantial fines, excise taxes, and other penalties, including possible loss of tax-exempt status. Although ERISA states that the plan is subject to certain of the penalties, the penalties are likely to fall not on the plan but on the sponsoring employer because Congress, in formulating ERISA, sought to protect plan assets for participants and their beneficiaries, not to protect employers from liability.

State Regulation of Employee Benefit Plans

A.40. ERISA was enacted with the intent of superseding all state laws affecting employee benefit plans that are subject to ERISA (sec. 514). Thus plans subject to the reporting, disclosure, fiduciary responsibility, eligibility, vesting, funding, and plan termination provisions of ERISA are not subject to state or local regulation of those aspects of plan operations. The preemption, however, would not extend to generally applicable criminal statutes or laws regulating insurance, banking, or securities.

A.41. Plans not covered by ERISA may be subject to regulation by various governmental units. Most public employee benefit plans are established pursuant to enabling legislation. Such legislation frequently prescribes standards for the operation of the plan and designates a governmental agency to regulate various aspects of the plan's operations. Plans established by local governmental units may be subject to both state and local requirements. Compliance requirements vary from state to state and among the various jurisdictions within a state, and the auditor should be familiar with the applicable laws and regulations.

Appendix B

Illustrations of Internal Accounting Control Objectives and Procedures

B.1. This appendix provides examples of specific internal accounting control objectives and selected control procedures and techniques for employee benefit plans. Its purpose is to illustrate the approach to the auditor's study and evaluation of internal accounting control. The illustrations are not intended to be all-inclusive or to suggest the specific objectives or control procedures and techniques that should be adopted by employee benefit plans. Some of the specific objectives may not be relevant to particular plans because of the type of plan or the absence of certain types of transactions. Certain plans may use a bank trust department or an insurance company to provide a measure of control over invested assets, and, as described in chapter 7, the plan auditor may decide to use the report on internal accounting control issued by the independent auditor of the bank or the insurance company.

B.2. The illustrations are arranged by the two broad objectives of reliability of financial records and safeguarding of assets as they relate to the various functions of employee benefit plans. These classifications may be useful in the evaluation process. Some of the specific objectives may serve to achieve more than one broad objective. Duplications in the illustrative objectives have been avoided, and the classifications are of secondary importance.

B.3. A premise of many of the illustrative procedures and techniques is the existence of certain essential characteristics of internal accounting control (for example, segregation of duties, documentation, training, supervision and review, and timeliness of procedures). To avoid duplication, these characteristics have not been emphasized in the illustrations.

Investments

Reliability of Financial Records		Safeguarding of Assets	
Specific objectives	*Examples of selected control procedures and techniques*	*Specific objectives*	*Examples of selected control procedures and techniques*
Investment transactions are recorded at the appropriate amount and in the appropriate period on a timely basis.	• Reports submitted by trustee or investment manager are reviewed. • Detailed subsidiary records are reconciled to the general ledger on a regular basis. • Report of trustee's independent auditor is reviewed.	Investment criteria and objectives are authorized, and investment strategies are executed in accordance with formal authorizations.	• Investment criteria or objectives are documented in the plan instrument or plan committee minutes. • Authority to execute transactions is specified in the plan instrument or plan committee minutes. • Investment transactions are reviewed by plan committee for adherence to criteria and objectives.
Investment income and expenses are recorded at the appropriate amount and in the appropriate period on a timely basis.	• Commissions and management fees are reviewed for reasonableness. • Interest and dividends are reviewed for accuracy by reference to reliable sources.	Investment assets are protected from loss or misappropriation.	• Responsibility for investment decisions and transactions is segregated from custodian's functions. • Securities that are physically held by the trustee periodically are physically counted on a surprise basis. • Written-off investments are reviewed for possible appreciation. • Documents are controlled in a limited-access, fireproof area. • Securities held by independent custodians are confirmed.
Investments (other than contracts with insurance companies) are measured at fair value.	• Quotation sources and appraisal reports are compared with recorded values. • Valuation methods are documented in the trust agreement or plan committee minutes. • Basis for "good faith" estimates is documented. • "Good faith" estimates are approved by plan committee.	Insurance companies can meet obligations under insurance contracts.	• Financial statements of insurance companies are reviewed. • Rating bureau reports are reviewed.
Premiums and interest relating to insurance contracts are recorded at the appropriate amount and in the appropriate period on a timely basis.	• Premium statements are compared with insurance contracts. • Interest amount calculation is tested. • List of current participants is reviewed.	For deposits with insurance companies, terms of insurance contracts are authorized.	• Terms are specified in the plan instrument. • Modifications of contracts are approved by the plan committee.

Contributions Received and Related Receivables

Reliability of Financial Records		*Safeguarding of Assets*	
Specific objectives	*Examples of selected control procedures and techniques*	*Specific objectives*	*Examples of selected control procedures and techniques*
Amounts of contributions by employers and participants meet authorized or required amounts.	• Contribution requirements or limitations are described in the plan instrument or collective bargaining agreement. • Contributions are determined using approved eligibility lists. • Actuary is used to make periodic valuations and reports.	Access to cash receipts, cash receipts records, and contribution records is suitably controlled to prevent or detect within a timely period the interception of unrecorded cash receipts or the abstraction of recorded cash receipts.	• Cash is independently controlled upon receipt. • Cash receipts are deposited intact daily. • Checks are restrictively endorsed upon receipt. • Responsibility for receiving and processing contributions is adequately segregated. • Bank accounts are reconciled monthly. • Past-due contributions are investigated on a timely basis.
Contributions are recorded at the appropriate amount and in the appropriate period on a timely basis.	• Sponsor or employer payroll records are compared with contribution calculations. • Initial controls are established over contribution forms. • Clerical accuracy of contribution forms is checked. • Subsidiary contribution records are reconciled to the general ledger. • Contribution forms are reconciled to cash receipts ledger and bank deposits. • Control totals for contributions withheld from participant records are maintained. • Contribution receipts are issued to participants containing notices requesting reviews of discrepancies.		

Benefit Payments

Reliability of Financial Records		*Safeguarding of Assets*	
Specific objectives	*Examples of selected control procedures and techniques*	*Specific objectives*	*Examples of selected control procedures and techniques*
Benefit payments are recorded at the appropriate amount and in the appropriate period on a timely basis.	• Benefit calculations supporting payments are checked for clerical accuracy. • Benefits payable outstanding for a long period are investigated. • Initial controls are established over benefit applications. • Benefit amounts are compared with plan or insurance company records. • Control totals for monthly pension benefits are maintained. • Participants or beneficiaries are notified of their right to have denied claims reviewed.	Benefit payments are determined and authorized in accordance with the plan instrument.	• Changes in participant eligibility are approved by the plan committee. • Eligibility lists are approved. • Signed benefit application forms are used. • Benefit applications that provide for review of eligibility, benefit amounts, or plan compliance require approval.
		Participants' benefit and cash disbursement records are controlled to prevent or detect on a timely basis unauthorized or duplicate payments.	• Responsibilities for benefit approval, recording of benefits, and maintenance of participant files are adequately segregated. • Blank forms are prenumbered and effectively controlled. • Periodic correspondence with retired beneficiaries is maintained, and correspondence or benefit payments are returnable to plan committee if undeliverable. • Benefit check endorsements are compared with signatures in applicable participant records. • Supporting documents are effectively canceled on payment.

Participants' Data and Plan Obligations

Reliability of Financial Records		*Safeguarding of Assets*	
Specific objectives	*Examples of selected control procedures and techniques*	*Specific objectives*	*Examples of selected control procedures and techniques*
Participant data is properly recorded on a timely basis.	• Enrollment applications are numerically controlled and are maintained for future reference. • The number of plan participants is reconciled using enrollment forms. • Subsidiary records are maintained for participants who are active, retired, or terminated with vested benefits. • Participants' subsidiary records are reconciled with general ledger. • Participants' data are updated and reconciled to employer's personnel and payroll records before being sent to actuary.	Participant eligibility is determined in accordance with authorization.	• Eligibility is defined in the plan instrument. • Enrollment applications are reviewed by the plan committee or a responsible official.
		Employees are notified of their eligibility.	• Procedures for identifying and contacting eligible employees are established. • Employee participation refusals are retained for future reference. • Benefit data are furnished to participants on written request.
Actuarial valuation of accumulated benefits reflects the understanding and agreement of the plan committee or responsible officials.	• Plan committee or responsible officials discuss with the actuary the actuarial methods and significant assumptions that are the basis for actuarial calculations.	Access to participants' data is controlled to prevent unauthorized changes or additions.	• Maintenance of participants' data is segregated from responsibility for benefit approval or processing.
Accumulated benefit amounts and other actuarially determined information are determined periodically and recorded in the plan's records at the appropriate amounts.	• Valuation report prepared by an enrolled actuary is reviewed. • Participants' data in the actuary's valuation report are reconciled with the participants' subsidiary records.		

Administrative Expenses

Reliability of Financial Records		*Safeguarding of Assets*	
Specific objectives	*Examples of selected control procedures and techniques*	*Specific objectives*	*Examples of selected control procedures and techniques*
Administrative expenses are recorded at the appropriate amount and in the appropriate period on a timely basis.	• Expenses are compared to disbursements. • If expenses are allocated to more than one plan, allocation methods and calculations are reviewed.	Types of administrative services to be offered are authorized.	• Administrative services are described in the plan instrument. • Expenses are approved by a responsible official.
		Access to accounts payable and cash disbursements records is controlled to prevent or detect on a timely basis unauthorized or duplicate payments.	• Responsibilities for expense approval and processing are adequately segregated. • Supporting documents are effectively canceled on payment.

Reporting

Reliability of Financial Records		*Safeguarding of Assets*	
Specific objectives	*Examples of selected control procedures and techniques*	*Specific objectives*	*Examples of selected control procedures and techniques*
Accounting records are maintained in sufficient detail to provide for proper accountability.	• General ledger entries are supported by subsidiary ledgers. • Subsidiary ledgers are reconciled with the general ledger on a periodic and timely basis. • Procedures are established to identify required disclosure items, for example, parties-in-interest transactions and transactions in excess of 3 percent of plan assets.	Direct and indirect access to the plan's records is controlled to protect against physical hazards and to prevent or detect on a timely basis unauthorized entries.	• Critical forms are prenumbered and controlled before and after issuance. • Record files are maintained in a controlled area with a suitable retention program. • Information pertinent to plan activities is identified and prepared for analysis.

Financial statements, actuarial information, and disclosures are prepared in conformity with management's authorization.	• Responsibility is assigned for accumulating information for disclosure in accordance with the rules and regulations of appropriate authorities. • Responsibility is assigned for review of all financial reports and filings. • Procedures are established for preparation and presentation of financial information. • Written representations on financial matters are obtained from actuaries, banks, insurance companies, and others. • Plan committee reviews presentation of, and disclosures in, financial reports.
Journal entries made are authorized.	• Journal entries are adequately documented in basic entry ledgers and are approved by a responsible official.
Accounting policies, including selections from among alternative principles, are adopted as authorized.	• Responsibility is assigned for approval of accounting policies.

Appendix C

Excerpt From FASB Statement no. 35
Accounting and Reporting by Defined Benefit Pension Plans

This appendix reproduces the standards of financial accounting and reporting by defined benefit pension plans from paragraphs 1 through 30 of FASB Statement no. 35. These standards are presented for the convenience of readers of this audit guide. A thorough understanding of these standards requires a reading of the entire statement, including its Appendix B, "Basis for Conclusions," and its Appendix D, "Illustration of Financial Statements." (The latter is reproduced in Appendix E of this guide.) The complete statement is available from the Financial Accounting Standards Board.

Statement of Financial Accounting Standards No. 35

Accounting and Reporting by Defined Benefit Pension Plans

March 1980

INTRODUCTION

1. This Statement establishes standards of financial accounting and reporting for the annual financial statements of a **defined benefit pension plan (pension plan** or **plan**).* Plans covered are those that principally provide **pension benefits** but may also provide **benefits** on death, disability, or termination of employment.

2. This Statement applies to an ongoing plan that provides pension benefits for the **employees** of one or more employers, including state and local governments, or for the members of a trade or other employee association. Such a plan may have no intermediary **funding agency** or it may be financed through one or more trust funds, one or more contracts with insurance companies, or a combination thereof. This Statement applies to plans that are subject to the provisions of the Employee Retirement Income Security Act of 1974 (**ERISA** or the **Act**) as well as to those that are not. It is not intended to apply to a plan that is expected to be terminated, nor to a government-sponsored social security plan. This Statement does not require the preparation, distribution, or attestation of any plan's financial statements (paragraph 51).

3. Standards of financial accounting and reporting for defined benefit pension plans are presented in paragraphs 4-30. Background information for this Statement is presented in Appendix A. The basis for the Board's conclusions, as well as alternatives considered and reasons for their rejection, are discussed in Appendix B. Illustrations of certain applications of the requirements of this Statement appear in Appendixes D and E.

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* Terms defined in the Glossary (Appendix C) are in boldface type the first time they appear in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Existing Generally Accepted Accounting Principles

4. Existing generally accepted accounting principles other than those discussed in this Statement may apply to the financial statements of defined benefit pension plans. The financial accounting standards discussed in this Statement are those of particular importance to pension plans or that differ from existing generally accepted accounting principles for other types of entities.

Primary Objective of Plan Financial Statements

5. The primary objective of a pension plan's financial statements is to provide financial information that is useful in assessing the plan's present and future ability to pay benefits when due.[1] To accomplish that objective, a plan's financial statements should provide information about (a) plan resources and how the stewardship responsibility for those resources has been discharged, (b) the **accumulated plan benefits** of **participants**, (c) the results of transactions and events that affect the information regarding those resources and benefits, and (d) other factors necessary for users to understand the information provided.

Financial Statements

6. The annual financial statements of a plan shall include:

a. A statement that includes information regarding the **net assets available for benefits** as of the end of the plan year
b. A statement that includes information regarding the changes during the year in the net assets available for benefits
c. Information regarding the **actuarial present value of accumu-**

[1] The Board recognizes that (a) information in addition to that contained in a plan's financial statements is needed in assessing the plan's present and future ability to pay benefits when due and (b) financial statements for several plan years can provide information more useful in assessing the plan's future ability to pay benefits than can the financial statements for a single plan year (paragraphs 58-63).

lated plan benefits as of either the beginning[2] or end of the plan year

d. Information regarding the effects, if significant, of certain factors affecting the year-to-year change in the actuarial present value of accumulated plan benefits.

7. The primary objective set forth in paragraph 5 is satisfied only if (a) information regarding both the net assets available for benefits and the actuarial present value of accumulated plan benefits is presented as of the same date and (b) information regarding both the changes in net assets available for benefits and the changes in the actuarial present value of accumulated plan benefits is presented for the same period. Therefore, if the **benefit information date** pursuant to paragraph 6(c) is the beginning of the year, a statement that includes information regarding the net assets available for benefits as of that date and a statement that includes information regarding the changes during the preceding year in the net assets available for benefits shall also be presented. Use of an end-of-year benefit information date is considered preferable. Plans are encouraged to develop procedures to enable them to use that date (paragraph 29).

8. The Board believes it is desirable to allow certain flexibility in presenting the information regarding the actuarial present value of accumulated plan benefits and the year-to-year changes therein. Therefore, either or both of those categories of information may be presented on the face of one or more financial statements or in notes thereto. Regardless of the format selected, each category of information shall be presented in its entirety in the same location. If a statement format is selected for either category, a separate statement may be used to present that information or, provided the information is as of the same date or for the same period, that information may be presented together with information regarding the net assets available for benefits and the year-to-year changes therein.

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[2] Financial information presented as of the beginning of the year shall be the amounts as of the end of the preceding year.

Net Assets Available for Benefits

9. The accrual basis of accounting[3] shall be used in preparing information regarding the net assets available for benefits. The information shall be presented in such reasonable detail as is necessary to identify the plan's resources that are available for benefits.

Contributions Receivable

10. Contributions receivable are the amounts due as of the **reporting date** to the plan from the employer(s), participants, and other sources of funding (for example, state subsidies or federal grants—which shall be separately identified). Amounts due include those pursuant to formal commitments as well as legal or contractual requirements. With respect to an employer's contributions, evidence of a formal commitment may include (a) a resolution by the employer's governing body approving a specified contribution, (b) a consistent pattern of making payments after the plan's year-end pursuant to an established **funding policy** that attributes such subsequent payments to the preceding plan year, (c) a deduction of a contribution for federal tax purposes for periods ending on or before the reporting date, or (d) the employer's recognition as of the reporting date of a contribution payable to the plan.[4]

Investments

11. Plan investments, whether equity or debt securities, real estate, or other (excluding contracts with insurance companies) shall be presented at their fair value at the reporting date. The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation

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[3] The accrual basis requires that purchases and sales of securities be recorded on a trade-date basis. However, if the settlement date is after the reporting date and (a) the fair value of securities purchased or sold just before the reporting date does not change significantly from the trade date to the reporting date, and (b) the purchases or sales do not significantly affect the composition of the plan's assets available for benefits, accounting on a settlement-date basis for such sales and purchases is acceptable.

[4] The existence of accrued pension costs does not, by itself, provide sufficient support for recognition of a contribution receivable (paragraph 92).

sale. Fair value shall be measured by the market price if there is an active market for the investment. If there is not an active market for an investment but there is such a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows may aid in estimating fair value, provided the expected cash flows are discounted at a rate commensurate with the risk involved.[5]

12. Contracts with insurance companies shall be presented in the same manner as that contained in the annual report filed by the plan with certain governmental agencies pursuant to ERISA.[6] A plan not subject to ERISA shall similarly present its contracts with insurance companies, that is, as if the plan were subject to the reporting requirements of ERISA.

13. Information regarding a plan's investments shall be presented in enough detail to identify the types of investments and shall indicate whether reported fair values have been measured by quoted prices in an active market or are fair values otherwise determined. (Paragraphs 28(g) and 28(h) require certain additional disclosures related to investments.)

Operating Assets

14. Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) shall be presented at cost less accumulated depreciation or amortization.

Changes in Net Assets Available for Benefits

15. Information regarding changes in net assets available for benefits shall be presented in enough detail to identify the signifi-

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[5] For an indication of factors to be considered in determining the discount rate, see paragraphs 13 and 14 of APB Opinion No. 21, *Interest on Receivables and Payables*. If significant, the fair value of an investment shall reflect the brokerage commissions and other costs normally incurred in a sale.

[6] For 1979 plan years, the pertinent governmental reporting requirements relate to item 13 of either Form 5500 or Form 5500-C.

cant changes during the year. Minimum disclosure shall include:

a. The net appreciation (depreciation)[7] in fair value for each significant class of investments, segregated between investments whose fair values have been measured by quoted prices in an active market and those whose fair values have been otherwise determined
b. Investment income (exclusive of (a) above)
c. Contributions from the employer(s), segregated between cash and noncash contributions[8]
d. Contributions from participants, including those transmitted by the **sponsor**
e. Contributions from other identified sources (for example, state subsidies or federal grants)
f. Benefits paid to participants
g. Payments to insurance companies to purchase contracts that are excluded from plan assets[9]
h. Administrative expenses.

Actuarial Present Value of Accumulated Plan Benefits

16. Accumulated plan benefits are those future benefit payments that are attributable under the plan's provisions to employees' **service** rendered to the benefit information date. Accumulated plan benefits comprise benefits expected to be paid to (a) retired or terminated employees or their beneficiaries, (b) beneficiaries of deceased employees, and (c) present employees or their beneficiaries.

17. To the extent possible, plan provisions shall apply in measuring accumulated plan benefits. In some plans, benefits are a specified amount for each year of service. Even if a plan does not specify a benefit for each year of service, another of its provi-

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[7] Realized gains and losses on investments that were both bought and sold during the year shall be included.

[8] A noncash contribution shall be recorded at fair value. The nature of noncash contributions shall be described, either parenthetically or in a note.

[9] Paragraph 28(e) requires disclosure of the plan's dividend income related to excluded contracts and permits that income to be netted against item (g).

sions (for example, a provision applicable to terminated employees or to termination of the plan—if independent of funding patterns) may indicate how to measure accumulated plan benefits. If the benefit for each year of service is not stated by or clearly determinable from the provisions of the plan, the benefit shall be considered to accumulate in proportion to (a) the ratio of the number of years of service completed to the benefit information date to the number that will have been completed when the benefit will first be fully vested, if the type of benefit is includable in **vested benefits** (for example, a supplemental early retirement benefit that is a vested benefit after a stated number of years of service), or (b) the ratio of completed years of service to projected years of service upon anticipated separation from covered employment, if the type of benefit is not includable in vested benefits (for example, a death or disability benefit that is payable only if death or disability occurs during active service).

18. In measuring accumulated plan benefits, the following shall apply:

a. Except as indicated in (b) and (c) below, accumulated plan benefits shall be based on employees' history of pay and service and other appropriate factors as of the benefit information date.[10]
b. Projected years of service shall be a factor only in determining employees' expected eligibility for particular benefits, such as:
   i. Increased benefits that are granted provided a specified number of years of service are rendered (for example, a pension benefit that is increased from $9 per month to $10 per month for each year of service if 20 or more years of service are rendered)
   ii. Early retirement benefits
   iii. Death benefits
   iv. Disability benefits.
c. Automatic benefit increases specified by the plan (for example, automatic cost-of-living increases) that are expected to occur after the benefit information date shall be recognized.

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[10] An example of the application of paragraphs 18(a) and 18(b) appears in Appendix E.

d. Benefits to be provided by means of contracts excluded from plan assets for which payments to the insurance company have been made shall be excluded.
e. Plan amendments adopted after the benefit information date shall not be recognized.
f. If it is necessary to take future compensation into account in the determination of Social Security benefits, employees' compensation as of the benefit information date shall be assumed to remain unchanged during their assumed future service. Increases in the wage base or benefit level pursuant to either the existing Social Security law or possible future amendments of the law shall not be recognized.

19. The actuarial present value of accumulated plan benefits is that amount as of the benefit information date that results from applying actuarial assumptions to the benefit amounts determined pursuant to paragraphs 16-18, with the actuarial assumptions being used to adjust those amounts to reflect the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as for death, disability, withdrawal, or retirement) between the benefit information date and the expected date of payment.

20. An assumption of an ongoing plan shall underlie the other assumptions used in determining the actuarial present value of accumulated plan benefits. Every other significant assumption used in that determination and disclosed pursuant to paragraph 27(b) shall reflect the best estimate of the plan's future experience solely with respect to that individual assumption. As to certain assumptions, the following shall apply:

a. Assumed rates of return shall reflect the expected rates of return during the periods for which payment of benefits is deferred and shall be consistent with returns realistically achievable on the types of assets held by the plan and the plan's investment policy. To the extent that assumed rates of return are based on values of existing plan assets, the values used in determining assumed rates of return shall be the values presented in the plan's financial statements pursuant to the requirements of this Statement.
b. Expected rates of inflation assumed in estimating automatic

cost-of-living adjustments shall be consistent with the assumed rates of return.

c. Administrative expenses expected to be paid by the plan (not those paid by the sponsor) that are associated with providing accumulated plan benefits shall be reflected either by appropriately adjusting the assumed rates of return or by assigning those expenses to future periods and discounting them to the benefit information date. If the former method is used, the adjustment of the assumed rates of return shall be separately disclosed (paragraph 27(b)).

21. In selecting certain assumptions to be used in determining the actuarial present value of accumulated plan benefits, an acceptable alternative to that discussed in paragraph 20 is to use those assumptions that are inherent in the estimated cost at the benefit information date to obtain a contract with an insurance company to provide participants with their accumulated plan benefits. Those other assumptions that are necessary but are not inherent in that estimated cost shall be selected pursuant to the requirements in paragraph 20.

Presentation of the Actuarial Present Value of Accumulated Plan Benefits

22. The total actuarial present value of accumulated plan benefits as of the benefit information date shall be segmented into at least the following categories:

a. Vested benefits of participants currently receiving payments
b. Other vested benefits
c. Nonvested benefits.

Category (a) shall include those benefits due and payable as of the benefit information date. Present employees' accumulated contributions as of the benefit information date (including interest, if any) shall be disclosed. If interest has been credited on employees' contributions, the rate(s) shall be disclosed.

Changes in the Actuarial Present Value of Accumulated Plan Benefits

23. Changes in actuarial assumptions made to reflect changes in the plan's expected experience shall be viewed as changes in

estimates. That is, the effects of those changes shall be accounted for in the year of change (or in the year of change and future years if the change affects both) and shall not be accounted for by restating amounts reported in financial statements for prior years or by reporting pro forma amounts for prior years.

24. Assumed rates of return used to determine the actuarial present value of accumulated plan benefits may change periodically due to changes in expected rates of return or as changes occur in the factors affecting estimates. A change in assumed rates of return need not necessarily result when a decision is made to replace fixed-income securities currently held with lower-rated fixed-income securities because the higher yield associated with the lower-rated securities reflects increased risk. Accordingly, a higher ultimate return on the aggregate investment portfolio may not result.

Presentation of Changes in the Actuarial Present Value of Accumulated Plan Benefits

25. If significant, either individually or in the aggregate, the effects of certain factors affecting the change in the actuarial present value of accumulated plan benefits from the preceding to the current benefit information date shall be identified. Effects that are individually significant shall be separately identified. Minimum disclosure shall include the significant effects of factors such as the following:

a. Plan amendments
b. Changes in the nature of the plan (for example, a plan spin-off or a merger with another plan)
c. Changes in actuarial assumptions.[11]

The significant effects of other factors may also be identified,

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[11] Plans that measure the actuarial present value of accumulated plan benefits by insurance company rates pursuant to the alternative approach described in paragraph 21 shall, if practicable, disclose the effects of changes in actuarial assumptions reflected in changes in those insurance rates.

including, for example, benefits accumulated,[12] the increase (for interest) as a result of the decrease in the discount period, and benefits paid. If presented, *benefits paid* shall not include benefit payments made by an insurance company in accordance with a contract that is excluded from plan assets. However, amounts paid by the plan to an insurance company pursuant to such a contract (including purchasing annuities with amounts allocated from existing investments with the insurance company) shall be included in *benefits paid*.[13] If the minimum required disclosure is presented in other than a statement format, the actuarial present value of accumulated plan benefits as of the preceding benefit information date shall also be presented.

26. Information regarding changes in the actuarial present value of accumulated plan benefits may be presented either (a) in a statement that accounts for the change between two benefit information dates or (b) elsewhere in the financial statements. If only the minimum required disclosure is presented, presentation in a statement format will necessitate an additional unidentified "other" category to reconcile the beginning and ending amounts.

Additional Financial Statement Disclosures

27. Disclosure of the plan's accounting policies[14] shall include the following:

a. A description of the method(s) and significant assumptions used to determine the fair value of investments and the reported value of contracts with insurance companies.

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[12] Actuarial experience gains or losses may be included with the effects of additional benefits accumulated rather than being separately disclosed. If the effects of changes in actuarial assumptions discussed in footnote 11 cannot be separately disclosed, those effects shall be included in benefits accumulated.

[13] Due to the use of different actuarial assumptions, the amount paid by the plan to an insurance company may be different from the previous measure of the actuarial present value of the related accumulated plan benefits. That difference is an actuarial experience gain or loss (footnote 12).

[14] See APB Opinion No. 22, *Disclosure of Accounting Policies*.

b. A description of the method and significant assumptions (for example, assumed rates of return, inflation rates, and retirement ages) used to determine the actuarial present value of accumulated plan benefits. Any significant changes of method or assumptions between benefit information dates shall be described.

28. The financial statements shall include the following additional disclosures, if applicable:

a. A brief, general description of the plan agreement, including—but not limited to—vesting and benefit provisions.[15]
b. A description of significant plan amendments adopted during the year ending on the latest benefit information date. If significant amendments were adopted between the latest benefit information date and the plan's year-end, it shall be indicated that the actuarial present value of accumulated plan benefits does not reflect those amendments.
c. A brief, general description of (i) the priority order of participants' claims to the assets of the plan upon plan termination and (ii) benefits guaranteed by the Pension Benefit Guaranty Corporation (**PBGC**), including a discussion of the application of the PBGC guaranty to any recent plan amendment.[16]
d. The funding policy and any changes in such policy during the plan year.[17] For a **contributory plan**, the disclosure shall state

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[15] If a plan agreement or a description thereof providing this information is otherwise published and made available, the description required by paragraph 28(a) may be omitted provided that reference to such other source is made.

[16] If material providing this information is otherwise published and made available to participants, the descriptions required by paragraph 28(c) may be omitted provided that (a) reference to such other source is made and (b) disclosure similar to the following is made in the financial statements: "Should the plan terminate at some future time, its net assets generally will not be available on a pro rata basis to provide participants' benefits. Whether a particular participant's accumulated plan benefits will be paid depends on both the priority of those benefits and the level of benefits guaranteed by the PBGC at that time. Some benefits may be fully or partially provided for by the then existing assets and the PBGC guaranty while other benefits may not be provided for at all."

[17] If significant costs of plan administration are being absorbed by the employer(s), that fact shall be disclosed.

the method of determining participants' contributions. Plans subject to ERISA shall disclose whether the minimum funding requirements of ERISA have been met. If a minimum funding waiver has been granted by the Internal Revenue Service *(IRS)* or if a request for a waiver is pending before the IRS, that fact shall be disclosed.

e. The policy regarding the purchase of contracts with insurance companies that are excluded from plan assets. The plan's dividend income for the year that is related to excluded contracts shall be disclosed, and for purposes of paragraph 15 may be netted against item (g).

f. The federal income tax status of the plan, if a favorable letter of determination has not been obtained or maintained.

g. Identification of investments that represent five percent or more of the net assets available for benefits.

h. Significant real estate or other transactions in which the plan and any of the following parties are jointly involved: (i) the sponsor, (ii) the employer(s), or (iii) the employee organization(s).

i. Unusual or infrequent events or transactions occurring after the latest benefit information date but before issuance of the financial statements that might significantly affect the usefulness of the financial statements in an assessment of the plan's present and future ability to pay benefits. For example, a plan amendment adopted after the latest benefit information date that significantly increases future benefits that are attributable to employees' service rendered before that date shall be disclosed. If reasonably determinable, the effects of such events or transactions shall be disclosed. If such effects are not quantified, the reasons why they are not reasonably determinable shall be disclosed.

Use of Averages or Reasonable Approximations

29. The Board recognizes that literal application of certain of the requirements of this Statement could require a degree of detail in recordkeeping and computation that might be unduly burdensome. Accordingly, the use of averages or other methods of approximation is appropriate, provided the results obtained are substantially the same as the results contemplated by this

Statement. Thus, rolling back to the beginning of the year or projecting to the end of the year detailed employee service-related data as of a date within the year may be acceptable in approximating beginning- or end-of-year **benefit information.** The use of averages and other methods of approximation consistent with recommended actuarial practice may be useful in conjunction with other provisions of this Statement, particularly when applied to plans sponsored by small employers. If participants' individual historical salary data for plan years before the effective date of this Statement are not available, reasonable approximations thereof are acceptable.

Effective Date and Transition

30. This Statement shall be effective for plan years beginning after December 15, 1980, except that it shall be effective for plan years beginning after June 15, 1982 for plans that are sponsored by, and provide benefits for the employees of, one or more state or local governments.* Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this Statement shall be made retroactively. Financial statements of prior plan years are required to be restated to comply with the provisions of this Statement *only* if presented together with financial statements for plan years beginning after December 15, 1980. If accounting changes were necessary to conform to the provisions of this Statement, that fact shall be disclosed when financial statements for the year in which this Statement is first applied are presented either alone or only with financial statements of prior years.

The provisions of this Statement need not be applied to immaterial items.

*[As amended by FASB Statement no. 59, *Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Governmental Units* (April 1982). — Editor]

Appendix D

Glossary

This appendix defines certain terms, acronyms, and phrases used for convenience in this Statement.

Accumulated plan benefits
Benefits that are attributable under the provisions of a pension plan to employees' service rendered to the benefit information date.

Act
The Employee Retirement Income Security Act of 1974.

Actuarial asset value
A value assigned by an actuary to the assets of a plan generally for use in conjunction with an actuarial cost method.

Actuarial cost method
A recognized actuarial technique used for establishing the amount and incidence of employer contributions or accounting charges for pension cost under a pension plan.

Actuarial present value of accumulated plan benefits
The amount as of a benefit information date that results from applying actuarial assumptions to the benefit amounts determined pursuant to paragraphs 16-18 of this Statement (that is, the accumulated plan benefits), with the actuarial assumptions being used to adjust those amounts to reflect the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as for death, disability, withdrawal, or retirement) between the benefit information date and the expected date of payment.

Allocated contract
A contract with an insurance company under which related payments to the insurance company are currently used to purchase immediate or deferred annuities for individual participants.

Source: FASB Statement no. 35, Appendix C.

Benefit information

The actuarial present value of accumulated plan benefits.

Benefit information date

The date as of which the actuarial present value of accumulated plan benefits is presented.

Benefit security

The plan's present and future ability to pay benefits when due.

Benefits

Payments to which participants may be entitled under a pension plan, including pension benefits, disability benefits, death benefits, and benefits due on termination of employment.

Contract value

The value of an unallocated contract that is determined by the insurance company in accordance with the terms of the contract.

Contributory plan

A pension plan under which participants bear part of the cost.

Defined benefit pension plan

A pension plan that specifies a determinable pension benefit, usually based on factors such as age, years of service, and salary. Even though a plan may be funded pursuant to periodic agreements that specify a fixed rate of employer contributions (for example, a collectively bargained multiemployer plan), such a plan may nevertheless be a defined benefit pension plan as that term is used in this Statement. For example, if the plan prescribes a scale of benefits and experience indicates or it is expected that employer contributions are or will be periodically adjusted to enable such stated benefits to be maintained, this Statement considers such a plan to be a defined benefit pension plan. Further, a plan that is subject to ERISA and considered to be a defined benefit pension plan under the Act is a defined benefit pension plan for purposes of applying this Statement.

Employee
A person who has rendered or is presently rendering service.

ERISA
The Employee Retirement Income Security Act of 1974.

ERISA plan
A plan that is subject to ERISA.

Funding agency
An organization or individual, such as a specific corporate or individual trustee or an insurance company, that provides facilities for the accumulation of assets to be used for paying benefits under a pension plan; an organization, such as a specific life insurance company, that provides facilities for the purchase of such benefits.

Funding policy
The program regarding the amounts and timing of contributions by the employer(s), participants, and any other sources (for example, state subsidies or federal grants) to provide the benefits a pension plan specifies.

General account
An undivided fund maintained by an insurance company that commingles plan assets with other assets of the insurance company for investment purposes. That is, funds held by an insurance company that are not maintained in a separate account are in its general account.

Net asset information
Information regarding the net assets available for benefits.

Net assets available for benefits
The difference between a plan's assets and its liabilities. For purposes of this definition, a plan's liabilities do not include participants' accumulated plan benefits.

Noncontributory plan
A pension plan under which participants do not make contributions.

Nonvested benefit information
The actuarial present value of nonvested accumulated plan benefits.

Participant
Any employee or former employee, or any member or former member of a trade or other employee association, or the beneficiaries of those individuals, for whom there are accumulated plan benefits.

Participating contract
An allocated contract that provides for plan participation in the investment performance and experience (for example, mortality experience) of the insurance company.

Participation right
A plan's right under a participating contract to receive future dividends from the insurance company.

PBGC
The Pension Benefit Guaranty Corporation.

Pension benefits
Periodic (usually monthly) payments made to a person who has retired from employment.

Pension fund
The assets of a pension plan held by a funding agency.

Pension plan
See **defined benefit pension plan.**

Plan
See **defined benefit pension plan.**

Plan administrator
The person or group of persons responsible for the content and issuance of a plan's financial statements in much the same way that *management* is responsible for the content and issuance of a business enterprise's financial statements.

Prior service costs

See **supplemental actuarial value.**

Reporting date

The date as of which information regarding the net assets available for benefits is presented.

Retired life fund

That portion of the funds under an immediate participation guarantee contract that is designated as supporting benefit payments to current retirees.

Separate account

A special account established by an insurance company solely for the purpose of investing the assets of one or more plans. Funds in a separate account are not commingled with other assets of the insurance company for investment purposes.

Service

Periods of employment taken into consideration under a pension plan.

Sponsor

In the case of a pension plan established or maintained by a single employer, the employer; in the case of a plan established or maintained by an employee organization, the employee organization; in the case of a plan established or maintained jointly by two or more employers or by one or more employers and one or more employee organizations, the association, committee, joint board of trustees, or other group of representatives of the parties who have established or who maintain the pension plan.

Supplemental actuarial value

The amount assigned under the actuarial cost method in use to years before a given date.

Unallocated contract

A contract with an insurance company under which related payments to the insurance company are accumulated in an unallocated fund to be used to meet benefit payments when employees retire, either directly or through the purchase of annuities. Funds in an unallocated contract may also be withdrawn and otherwise invested.

Vested benefit information

The actuarial present value of vested accumulated plan benefits.

Vested benefits

Benefits that are not contingent on an employee's future service.

Appendix E

Illustration of Financial Statements: Defined Benefit Pension Plan

This appendix illustrates certain applications of the requirements of this Statement that are applicable for the 1981 annual financial statements of a hypothetical plan, the C&H Company Pension Plan. It does not illustrate other requirements of this Statement that might be applicable in circumstances other than those assumed for the C&H Company Pension Plan. The formats presented and the wording of accompanying notes are only illustrative and do not necessarily reflect a preference of the Board. Further, the circumstances assumed for the C&H Company Pension Plan are designed to facilitate illustration of many of this Statement's requirements. Therefore, the notes to the illustrative financial statements probably are more extensive than would be expected for a typical plan.

Included are illustrations of the following alternatives permitted by paragraphs 6, 8, 25, and 26:

a. An end-of-year vs. beginning-of-year benefit information date
b. Separate vs. combined statements for presenting information regarding (a) the net assets available for benefits and the actuarial present value of accumulated plan benefits and (b) changes in the net assets available for benefits and changes in the actuarial present value of accumulated plan benefits
c. A separate statement that reconciles the year-to-year change in the actuarial present value of accumulated plan benefits vs. presenting the effects of a change in actuarial assumptions on the face of the statement of accumulated plan benefits.

Although not illustrated, paragraph 8 of this Statement permits the information regarding the actuarial present value of accumulated plan benefits and changes therein to be presented as notes to the financial statements.

Source: FASB Statement no. 35, Appendix D.

CONTENTS

Exhibit D-1

C&H COMPANY PENSION PLAN

STATEMENT OF NET ASSETS AVAILABLE FOR BENEFITS

	December 31 1981
Assets	
Investments, at fair value (Notes B(1) and E)	
United States government securities	$ 350,000
Corporate bonds and debentures	3,500,000
Common stock	
C&H Company	690,000
Other	2,250,000
Mortgages	480,000
Real estate	270,000
	7,540,000
Deposit administration contract, at contract value (Notes B(1) and F)	1,000,000
Total investments	8,540,000
Receivables	
Employees' contributions	40,000
Securities sold	310,000
Accrued interest and dividends	77,000
	427,000
Cash	200,000
Total assets	9,167,000
Liabilities	
Accounts payable	70,000
Accrued expenses	85,000
Total liabilities	155,000
Net assets available for benefits	$9,012,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-2

C&H COMPANY PENSION PLAN

STATEMENT OF CHANGES IN NET ASSETS AVAILABLE FOR BENEFITS

	Year Ended December 31 1981
Investment income	
Net appreciation in fair value of investments (Note E)	$ 207,000
Interest	345,000
Dividends	130,000
Rents	55,000
	737,000
Less investment expenses	39,000
	698,000
Contributions (Note C)	
Employer	780,000
Employees	450,000
	1,230,000
Total additions	1,928,000
Benefits paid directly to participants	740,000
Purchases of annuity contracts (Note F)	257,000
	997,000
Administrative expenses	65,000
Total deductions	1,062,000
Net increase	866,000
Net assets available for benefits	
Beginning of year	8,146,000
End of year	$9,012,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-3

C&H COMPANY PENSION PLAN

STATEMENT OF ACCUMULATED PLAN BENEFITS

	December 31 1981
Actuarial present value of accumulated plan benefits (Notes B(2) and C)	
Vested benefits	
Participants currently receiving payments	$ 3,040,000
Other participants	8,120,000
	11,160,000
Nonvested benefits	2,720,000
Total actuarial present value of accumulated plan benefits	$13,880,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-4

C&H COMPANY PENSION PLAN

STATEMENT OF CHANGES IN ACCUMULATED PLAN BENEFITS

	Year Ended December 31 1981
Actuarial present value of accumulated plan benefits at beginning of year	$11,880,000
Increase (decrease) during the year attributable to:	
Plan amendment (Note G)	2,410,000
Change in actuarial assumptions (Note B(2))	(1,050,500)
Benefits accumulated	895,000
Increase for interest due to the decrease in the discount period (Note B(2))	742,500
Benefits paid	(997,000)
Net increase	2,000,000
Actuarial present value of accumulated plan benefits at end of year	$13,880,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-5

C&H COMPANY PENSION PLAN

STATEMENT OF ACCUMULATED PLAN BENEFITS AND NET ASSETS AVAILABLE FOR BENEFITS [An alternative for Exhibits D-1 and D-3]

	December 31 1981
Accumulated Plan Benefits (Notes B(2) and C)	
Actuarial present value of vested benefits	
Participants currently receiving payments	$ 3,040,000
Other participants	8,120,000
	11,160,000
Actuarial present value of nonvested benefits	2,720,000
Total actuarial present value of accumulated plan benefits	13,880,000
Net Assets Available for Benefits	
Investments, at fair value (Note B(1) and E)	
United States government securities	350,000
Corporate bonds and debentures	3,500,000
Common stock	
C&H Company	690,000
Other	2,250,000
Mortgages	480,000
Real estate	270,000
	7,540,000
Deposit administration contract, at contract value (Notes B(1) and F)	1,000,000
Total investments	8,540,000
Receivables	
Employees' contributions	40,000
Securities sold	310,000
Accrued interest and dividends	77,000
	427,000
Cash	200,000
Total assets	9,167,000
Accounts payable	70,000
Accrued expenses	85,000
Total liabilities	155,000
Net assets available for benefits	9,012,000
Excess of actuarial present value of accumulated plan benefits over net assets available for benefits	$ 4,868,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-6

C&H COMPANY PENSION PLAN

STATEMENT OF CHANGES IN ACCUMULATED PLAN BENEFITS AND NET ASSETS AVAILABLE FOR BENEFITS
[An alternative for Exhibits D-2 and D-4]

	Year Ended December 31 1981
Net Increase in Actuarial Present Value of Accumulated Plan Benefits	
Increase (decrease) during the year attributable to:	
Plan amendment (Note G)	$ 2,410,000
Change in actuarial assumptions (Note B(2))	(1,050,500)
Benefits accumulated	895,000
Increase for interest due to the decrease in the discount period (Note B(2))	742,500
Benefits paid	(997,000)
Net increase	2,000,000
Net Increase in Net Assets Available for Benefits	
Investment income	
Net appreciation in fair value of investments (Note E)	207,000
Interest	345,000
Dividends	130,000
Rents	55,000
	737,000
Less investment expenses	39,000
	698,000
Contributions (Note C)	
Employer	780,000
Employees	450,000
	1,230,000
Total additions	1,928,000
Benefits paid directly to participants	740,000
Purchases of annuity contracts (Note F)	257,000
	997,000
Administrative expenses	65,000
Total deductions	1,062,000
Net increase	866,000
Increase in excess of actuarial present value of accumulated plan benefits over net assets available for benefits	1,134,000
Excess of actuarial present value of accumulated plan benefits over net assets available for benefits	
Beginning of year	3,734,000
End of year	$ 4,868,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-7

C&H COMPANY PENSION PLAN

STATEMENT OF NET ASSETS AVAILABLE FOR BENEFITS
[If a beginning-of-year benefit information date is selected]

	December 31	
	1981	1980
Assets		
Investments, at fair value (Notes B(1) and E)		
United States government securities	$ 350,000	$ 270,000
Corporate bonds and debentures	3,500,000	3,670,000
Common stock		
C&H Company	690,000	880,000
Other	2,250,000	1,860,000
Mortgages	480,000	460,000
Real estate	270,000	240,000
	7,540,000	7,380,000
Deposit administration contract, at contract value (Notes B(1) and F)	1,000,000	890,000
Total investments	8,540,000	8,270,000
Receivables		
Employees' contributions	40,000	35,000
Securities sold	310,000	175,000
Accrued interest and dividends	77,000	76,000
	427,000	286,000
Cash	200,000	90,000
Total assets	9,167,000	8,646,000
Liabilities		
Accounts payable		
Securities purchased	—	400,000
Other	70,000	60,000
	70,000	460,000
Accrued expenses	85,000	40,000
Total liabilities	155,000	500,000
Net assets available for benefits	$9,012,000	$8,146,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-8

C&H COMPANY PENSION PLAN

STATEMENT OF CHANGES IN NET ASSETS AVAILABLE FOR BENEFITS
[If a beginning-of-year benefit information date is selected]

	Year Ended December 31	
	1981	1980
Investment income		
Net appreciation (depreciation) in fair value of investments (Note E)	$ 207,000	$ (72,000)
Interest	345,000	320,000
Dividends	130,000	110,000
Rents	55,000	43,000
	737,000	401,000
Less investment expenses	39,000	35,000
	698,000	366,000
Contributions (Note C)		
Employer	780,000	710,000
Employees	450,000	430,000
	1,230,000	1,140,000
Total additions	1,928,000	1,506,000
Benefits paid directly to participants	740,000	561,000
Purchases of annuity contracts (Note F)	257,000	185,000
	997,000	746,000
Administrative expenses	65,000	58,000
Total deductions	1,062,000	804,000
Net increase	866,000	702,000
Net assets available for benefits		
Beginning of year	8,146,000	7,444,000
End of year	$9,012,000	$8,146,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-9

C&H COMPANY PENSION PLAN

STATEMENT OF ACCUMULATED PLAN BENEFITS
[If a beginning-of-year benefit information date is selected]

	December 31 1980
Actuarial present value of accumulated plan benefits (Notes B(2) and C)	
Vested benefits	
Participants currently receiving payments	$ 2,950,000
Other participants	6,530,000
	9,480,000
Nonvested benefits	2,400,000
Total actuarial present value of accumulated plan benefits	$11,880,000

At December 31, 1979, the total actuarial present value of accumulated plan benefits was $10,544,000. During 1980, the actuarial present value of accumulated plan benefits increased $700,000 as a result of a change in actuarial assumptions (Note B(2)). Also see Note G.

The accompanying notes are an integral part of the financial statements.

C&H COMPANY PENSION PLAN

NOTES TO FINANCIAL STATEMENTS[46]

A. Description of Plan

The following brief description of the C&H Company Pension Plan (*Plan*) is provided for general information purposes only. Participants should refer to the Plan agreement for more complete information.

1. *General.* The Plan is a defined benefit pension plan covering substantially all employees of C&H Company (*Company*). It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (*ERISA*).
2. *Pension Benefits.* Employees with 10 or more years of service are entitled to annual pension benefits beginning at normal retirement age (65) equal to 1½% of their final 5-year average annual compensation for each year of service. The Plan permits early retirement at ages 55-64. Employees may elect to receive their pension benefits in the form of a joint and survivor annuity. If employees terminate before rendering 10 years of service, they forfeit the right to receive the portion of their accumulated plan benefits attributable to the Company's contributions. Employees may elect to receive the value of their accumulated plan benefits as a lump-sum distribution upon retirement or termination, or they may elect to receive their benefits as a life annuity payable monthly from retirement. For each employee electing a life annuity, payments will not be less than the greater of (a) the employee's accumulated contributions plus interest or (b) an annuity for five years.
3. *Death and Disability Benefits.* If an active employee dies at age 55 or older, a death benefit equal to the value of the employee's accumulated pension benefits is paid to the employee's beneficiary. Active employees who become

[46] The notes are for the accompanying illustrative financial statements that use an end-of-year benefit information date. Modifications necessary to accompany the illustrative financial statements that use a beginning-of-year benefit information date are presented in brackets.

totally disabled receive annual disability benefits that are equal to the normal retirement benefits they have accumulated as of the time they become disabled. Disability benefits are paid until normal retirement age at which time disabled participants begin receiving normal retirement benefits computed as though they had been employed to normal retirement age with their annual compensation remaining the same as at the time they became disabled.

B. Summary of Accounting Policies

The following are the significant accounting policies followed by the Plan:

1. *Valuation of Investments.* If available, quoted market prices are used to value investments. The amounts shown in Note E for securities that have no quoted market price represent estimated fair value. Many factors are considered in arriving at that fair value. In general, however, corporate bonds are valued based on yields currently available on comparable securities of issuers with similar credit ratings. Investments in certain restricted common stocks are valued at the quoted market price of the issuer's unrestricted common stock less an appropriate discount. If a quoted market price for unrestricted common stock of the issuer is not available, restricted common stocks are valued at a multiple of current earnings less an appropriate discount. The multiple chosen is consistent with multiples of similar companies based on current market prices.

   Mortgages have been valued on the basis of their future principal and interest payments discounted at prevailing interest rates for similar instruments. The fair value of real estate investments, principally rental property subject to long-term net leases, has been estimated on the basis of future rental receipts and estimated residual values discounted at interest rates commensurate with the risks involved.

   The Plan's deposit administration contract with the National Insurance Company (*National*) (Note F) is valued at contract value. Contract value represents contributions made under the contract, plus interest at the contract rate, less funds used to purchase annuities and pay administration expenses charged by National. Funds under the contract that have been allocated and applied to purchase annuities (that is, National is obligated to pay the related pension benefits) are excluded from the Plan's assets.

2. *Actuarial Present Value of Accumulated Plan Benefits.* Accumulated plan benefits are those future periodic payments, including lump-sum distributions, that are attributable under the Plan's provisions to the service employees have rendered. Accumulated plan benefits include benefits expected to be paid to (a) retired or terminated employees or their beneficiaries, (b) beneficiaries of employees who have died, and (c) present employees or their beneficiaries. Benefits under the Plan are based on employees' compensation during their last five years of credited service. The accumulated plan benefits for active employees are based on their average compensation during the five years ending on the date as of which the benefit information is presented (the *valuation date*). Benefits payable under all circumstances—retirement, death, disability, and termination of employment—are included, to the extent they are deemed attributable to employee service rendered to the valuation date. Benefits to be provided via annuity contracts excluded from plan assets are excluded from accumulated plan benefits.

   The actuarial present value of accumulated plan benefits is determined by an actuary from the AAA Company and is that amount that results from applying actuarial assumptions to adjust the accumulated plan benefits to reflect the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as for death, disability, withdrawal, or retirement) between the valuation date and the expected date of payment. The significant actuarial assumptions used in the valuations as of December 31, 1981 [1980] and December 31, 1980 [1979] were (a) life expectancy of participants (the 1971 Group Annuity Mortality Table was used), (b) retirement age assumptions (the assumed average retirement age was 60), and (c) investment return. The 1981 [1980] and 1980 [1979] valuations included assumed average rates of return of 7% [6.25%] and 6.25% [6.75%], respectively, including a reduction of .2% to reflect anticipated administrative expenses associated with providing benefits. The foregoing actuarial assumptions are based on the presumption that the Plan will continue. Were the Plan to terminate, different actuarial assumptions and other factors might be applicable in determining the actuarial present value of accumulated plan benefits.

C. Funding Policy

As a condition of participation, employees are required to contribute 3% of their salary to the Plan. Present employees' accumulated contributions at December 31, 1981 [1980] were $2,575,000 [$2,325,000], including interest credited at an interest rate of 5% compounded annually. The Company's funding policy is to make annual contributions to the Plan in amounts that are estimated to remain a constant percentage of employees' compensation each year (approximately 5% for 1981 [and 1980]), such that, when combined with employees' contributions, all employees' benefits will be fully provided for by the time they retire. Beginning in 1982, the Company's contribution is expected to increase to approximately 6% to provide for the increase in benefits attributable to the Plan amendment effective July 1, 1981 (Note G). The Company's contributions for 1981 [and 1980] exceeded the minimum funding requirements of ERISA.

Although it has not expressed any intention to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions set forth in ERISA.

D. Plan Termination

In the event the Plan terminates, the net assets of the Plan will be allocated, as prescribed by ERISA and its related regulations, generally to provide the following benefits in the order indicated:

a. Benefits attributable to employee contributions, taking into account those paid out before termination.

b. Annuity benefits former employees or their beneficiaries have been receiving for at least three years, or that employees eligible to retire for that three-year period would have been receiving if they had retired with benefits in the normal form of annuity under the Plan. The priority amount is limited to the lowest benefit that was payable (or would have been payable) during those three years. The amount is further limited to the lowest benefit that would be payable under plan provisions in effect at any time during the five years preceding plan termination.
c. Other vested benefits insured by the Pension Benefit Guaranty Corporation (*PBGC*) (a U.S. governmental agency) up to the applicable limitations (discussed below).
d. All other vested benefits (that is, vested benefits not insured by the PBGC).
e. All nonvested benefits.

Benefits to be provided via contracts under which National (Note F) is obligated to pay the benefits would be excluded for allocation purposes.

Certain benefits under the Plan are insured by the PBGC if the Plan terminates. Generally, the PBGC guarantees most vested normal age retirement benefits, early retirement benefits, and certain disability and survivor's pensions. However, the PBGC does not guarantee all types of benefits under the Plan, and the amount of benefit protection is subject to certain limitations. Vested benefits under the Plan are guaranteed at the level in effect on the date of the Plan's termination. However, there is a statutory ceiling on the amount of an individual's monthly benefit that the PBGC guarantees. For plan terminations occurring during 1981 and 1980, that ceiling which is adjusted periodically was $X,XXX.XX and $1,159.09 per month, respectively. That ceiling applies to those pensioners who elect to receive their benefits in the form of a single-life annuity and are at least 65 years old at the time of retirement or plan termination (whichever comes later). For younger annuitants or for those who elect to receive their benefits in some form more valuable than a single-life annuity, the corresponding ceilings are actuarially adjusted downward. Benefit improvements attributable to the Plan amendment effective

July 1, 1981 (Note G) may not be fully guaranteed even though total benefit entitlements fall below the aforementioned ceilings. For example, none of the improvement would be guaranteed if the plan were to terminate before July 1, 1982. After that date, the PBGC would guarantee 20% of any benefit improvements that resulted in benefits below the ceiling, with an additional 20% guaranteed each year the plan continued beyond July 1, 1982. If the amount of the benefit increase below the ceiling is also less than $100, $20 of the increase (rather than 20%) becomes guaranteed by the PBGC each year following the effective date of the amendment. As a result, only the primary ceiling would be applicable after July 1, 1986.

Whether all participants receive their benefits should the Plan terminate at some future time will depend on the sufficiency, at that time, of the Plan's net assets to provide those benefits and may also depend on the level of benefits guaranteed by the PBGC.

E. Investments Other Than Contract with Insurance Company

Except for its deposit administration contract (Note F), the Plan's investments are held by a bank-administered trust fund. The following table presents the fair values of those investments. Investments that represent 5% or more of the Plan's net assets are separately identified.

	December 31, 1981		December 31, 1980	
	Number of Shares or Principal Amount	Fair Value	Number of Shares or Principal Amount	Fair Value
Investments at Fair Value As Determined by Quoted Market Price				
United States government securities		$ 350,000		$ 270,000
Corporate bonds and debentures				
National Locomotive 6% series C bonds due 1990	$ 600,000	480,000	$ 600,000	492,000
General Design Corp. 5½% convertible debentures due 1993	$ 700,000	520,000	$ 350,000	250,000
Other		2,260,000		2,618,000
Common stocks				
C&H Company	25,000	690,000	25,000	880,000
Reliable Manufacturing Corp.	12,125	625,000	9,100	390,000
American Automotive, Inc.	5,800	475,000	6,800	510,000
Other		680,000		500,000
		6,080,000		5,910,000
Investments at Estimated Fair Value				
Corporate bonds and debentures		240,000		310,000
Common stocks		470,000		460,000
Mortgages		480,000		460,000
Real estate		270,000		240,000
		1,460,000		1,470,000
		$7,540,000		$7,380,000

During 1981 [and 1980], the Plan's investments (including investments bought, sold, as well as held during the year) appreciated [(depreciated)] in value by $207,000 [and ($72,000), respectively], as follows:

Net Appreciation (Depreciation) in Fair Value

	Year Ended December 31 1981	Year Ended December 31 1980
Investments at Fair Value as Determined by Quoted Market Price		
United States government securities	$ (10,000)	$ 8,000
Corporate bonds and debentures	(125,000)	50,000
Common stocks	228,000	(104,000)
	93,000	(46,000)
Investments at Estimated Fair Value		
Corporate bonds and debentures	(11,000)	9,000
Common stocks	100,000	(49,000)
Mortgages	(5,000)	4,000
Real estate	30,000	10,000
	114,000	(26,000)
	$ 207,000	$ (72,000)

F. Contract with Insurance Company

In 1978, the Company entered into a deposit administration contract with the National Insurance Company under which the Plan deposits a minimum of $100,000 a year. National maintains the contributions in an unallocated fund to which it adds interest at a rate of 8%. The interest rate is guaranteed through 1983 but is subject to change for each succeeding five-year period. When changed, the new rate applies only to funds deposited from the date of change. At the direction of the Plan's administrator, a single premium to buy an annuity for a retiring employee is withdrawn by National from the unallocated fund. Purchased annuities are contracts under which National is obligated to pay benefits to named employees or their beneficiaries. The premium rates for such annuities to be purchased in the future and maximum administration expense charges against the fund are also guaranteed by National on a five-year basis. The annuity contracts provide for periodic dividends at National's discretion on the basis of its experience under the contracts. Such dividends received by the Plan for the year[s] ended December 31, 1981 [and 1980] were $25,000 [and $24,000, respectively]. In reporting changes in net assets, those dividends have been netted against amounts paid to National for the purchase of annuity contracts.

G. Plan Amendment

Effective July 1, 1981, the Plan was amended to increase future annual pension benefits from 1¼% to 1½% of final 5-year average annual compensation for each year of service, including service rendered before the effective date. The retroactive effect of the Plan amendment, an increase in the actuarial present value of accumulated plan benefits of $2,410,000, was accounted for in the year ended December 31, 1981. [The actuarial present values of accumulated plan benefits at December 31, 1980 and December 31, 1979 do not reflect the effect of that Plan amendment. The Plan's actuary estimates that the amendment's retroactive effect on the actuarial present value of accumulated plan benefits at December 31, 1980 was an increase of approximately $1,750,000, of which approximately $1,300,000 represents an increase in vested benefits.]

H. Accounting Changes

In 1981, the Plan changed its method of accounting and reporting to comply with the provisions of Statement of Financial Accounting Standards No. 35 issued by the Financial Accounting Standards Board. Previously reported financial information pertaining to 1980 [and 1979] has been restated to present that information on a comparable basis.

Appendix F

Illustration of Financial Statements: Defined Contribution Plan

This appendix illustrates certain applications of the provisions of chapter 3 that apply for the 19X1 annual financial statements of a hypothetical plan, the XYZ Company Profit-Sharing Plan. It does not illustrate other provisions of chapter 3 that might apply in circumstances other than those assumed in this example. The formats presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations. For purposes of illustration, only single-year financial statements are shown.

XYZ Company Profit-Sharing Plan
Statement of Net Assets Available for Plan Benefits

	December 31 19X1
Assets	
Investments, at fair value (Notes B and C)	
U.S. government securities	$ 455,000
Corporate bonds and debentures	3,900,000
Common stock	3,822,000
	8,177,000
Deposit with insurance company, at contract value (Note D)	1,000,000
Total investments	9,177,000
Receivables	
Employer's contribution	14,000
Employees' contributions	52,000
Due from broker for securities sold	403,000
Accrued interest and dividends	77,000
	546,000
Cash	280,000
Total assets	10,003,000
Liabilities	
Accounts payable	10,000
Accrued expenses	100,000
Due to broker for securities purchased	75,000
Total liabilities	185,000
Net assets available for plan benefits	$ 9,818,000

The accompanying notes are an integral part of these financial statements.

XYZ Company Profit-Sharing Plan
Statement of Changes in Net Assets Available for Plan Benefits

	Year Ended December 31 19X1
Additions to net assets attributed to:	
Investment income	
Net appreciation in fair value of investments (Note C)	$ 269,000
Interest	449,000
Dividends	165,000
	883,000
Less investment expenses	(50,000)
	833,000
Contributions	
Employer	1,014,000
Employees	585,000
	1,599,000
Total additions	2,432,000
Deductions from net assets attributed to:	
Benefits paid to participants	1,050,000
Administrative expenses	105,000
Total deductions	1,155,000
Net increase	1,277,000
Net assets available for plan benefits	
Beginning of year	8,541,000
End of year	$9,818,000

The accompanying notes are an integral part of these financial statements.

XYZ Company Profit-Sharing Plan
Notes to Financial Statements

A. Description of Plan

The following description of the XYZ Company (Company) Profit-Sharing Plan (Plan) provides only general information. Participants should refer to the Plan agreement for a more complete description of the Plan's provisions.

1. *General.* The Plan is a defined contribution plan covering all full-time employees of the Company who have one year of service and

are age twenty-five or older. It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

2. *Contributions.* Each year, the Company contributes to the Plan 10 percent of its current profits before pension and profit-sharing costs and income taxes. Additional amounts may be contributed at the option of the Company's board of directors. Participants may contribute up to 10 percent of their annual wages before bonuses and overtime.
3. *Participant Accounts.* Each participant's account is credited with the participant's contribution and an allocation of *(a)* the Company's contribution, *(b)* Plan earnings, and *(c)* forfeitures of terminated participants' nonvested accounts. Allocations are based on participant earnings or account balances, as defined. The benefit to which a participant is entitled is the benefit that can be provided from the participant's account.
4. *Vesting.* Participants are immediately vested in their voluntary contributions plus actual earnings thereon. Vesting in the remainder of their accounts is based on years of continuous service. A participant is 100 percent vested after ten years of credited service.
5. *Payment of Benefits.* On termination of service, a participant may elect to receive either a lump-sum amount equal to the value of his or her account, or annual installments over a ten-year period.

B. Summary of Accounting Policies

If available, quoted market prices are used to value investments. The amounts shown in Note C for securities that have no quoted market price represent estimated fair value. Many factors are considered in arriving at fair value. In general, however, corporate bonds are valued based on yields currently available on comparable securities of issuers with similar credit ratings. Investments in certain restricted common stocks are valued at the quoted market price of the issuer's unrestricted common stock less an appropriate discount. If a quoted market price for unrestricted common stock of the issuer is not available, restricted common stocks are valued at a multiple of current earnings less an appropriate discount. The multiple chosen is consistent with multiples of similar companies based on current market prices.

C. Investments

Except for its deposit with an insurance company (Note D), the Plan's investments are held by a bank-administered trust fund. The following table presents the fair values of investments. Investments that represent 5 percent or more of the Plan's net assets are separately identified.

Fair Value of Investments

	December 31, 19X1	
	Number of Shares or Principal Amount	Fair Value
Investments at Fair Value as Determined by Quoted Market Price		
U.S. government securities		$ 455,000
Corporate bonds and debentures		
National Auto 7% bonds due 2000	$1,000,000	875,000
Other		2,775,000
Common Stocks		
Bizco Corporation	100,000	950,000
Other		2,497,000
		7,552,000
Investments at Estimated Fair Value		
Corporate bonds		250,000
Common stocks		375,000
		625,000
Total investments at fair value		$8,177,000

During 19X1 the Plan's investments (including investments bought, sold, and held during the year) appreciated in value by $269,000 as follows:

Net Appreciation (Depreciation) in Fair Value

	Year Ended December 31 19X1
Investments at Fair Value as Determined by Quoted Market Price	
U.S. government securities	$ (15,000)
Corporate bonds and debentures	(175,000)
Common stocks	439,000
	249,000
Investments at Estimated Fair Value	
Corporate bonds and debentures	(5,000)
Common stocks	25,000
	20,000
Net appreciation in fair value	$269,000

D. Deposit With Insurance Company

In 19X0, the Plan entered into a deposit contract with the National Insurance Company (National). National maintains the contributions in a pooled account. The account is credited with actual earnings on the underlying investments (principally bank certificates of deposit) and charged for plan withdrawals and administration expenses charged by National. The contract is included in the financial statements at the December 31, 19X1 contract value as reported to the Plan by National.

E. Plan Termination

Although it has not expressed any intent to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions of ERISA. In the event of plan termination, participants will become 100 percent vested in their accounts.

Appendix G

Illustrations of Financial Statements: Employee Health and Welfare Benefit Plan and Vacation Benefit Plan

This appendix illustrates certain applications of the provisions of chapter 4 that apply for the annual financial statements of a hypothetical self-insured health and welfare benefit plan, the Bizco Corporation Employee Health and Welfare Benefit Plan, and a hypothetical vacation benefit plan, the UAGW Vacation Benefit Plan. It does not illustrate other provisions of chapter 4 that might apply in circumstances other than those assumed in these examples. The format presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations. For purposes of illustration, only single-year financial statements are shown.

Employee Health and Welfare Benefit Plan

Bizco Corporation Employee Health and Welfare Benefit Plan
Statement of Net Assets

	December 31 19X1
Assets	
Investments, at fair value (Notes B and D)	
U.S. government securities	$1,171,000
Corporate bonds and debentures	360,000
Common stock	219,000
Total investments	1,750,000
Receivables	
Employer's contributions (Note A)	562,000
Employees' contributions (less allowance for doubtful accounts of $4,000)	138,000
Accrued interest and dividends	25,000
Due from broker for securities sold	31,000
	756,000
Cash	58,000
Total assets	2,564,000
Liabilities	
Health claims payable	402,000
Estimated health claims incurred but not reported	182,000
Estimated future benefits based on participant's accumulated eligibility (Note A)	592,000
Estimated future benefits to retired participants	385,000
Estimated future death benefits	315,000
Due to broker for securities purchased	35,000
Other liabilities	38,000
Total liabilities	1,949,000
Net assets	$ 615,000

The accompanying notes are an integral part of these financial statements.

Bizco Corporation Employee Health and Welfare Benefit Plan
Statement of Changes in Net Assets

	Year Ended December 31 19X1
Additions to plan assets attributed to:	
Investment income	
Net appreciation in fair value of investments (Note D)	$ 12,000
Interest	165,000
Dividends	7,000
	184,000
Less investment expenses	(11,000)
	173,000
Employer's contributions (Notes A and C)	2,320,000
Employees' contributions	833,000
Total additions	3,326,000
Deductions from plan assets attributed to:	
Payments for—	
Health claims	2,683,000
Retired participants' benefits	173,000
Death benefits	112,000
	2,968,000
Additions to liabilities for—	
Health claims (Note C)	134,000
Participants' accumulated eligibility	75,000
Future benefits to retired participants	29,000
Death benefits	12,000
Administrative expenses	166,000
Total deductions	3,384,000
Net decrease	(58,000)
Net assets	
Beginning of year	673,000
End of year	$615,000

The accompanying notes are an integral part of these financial statements.

Bizco Corporation Employee Health and Welfare Benefit Plan
Notes to Financial Statements

A. Description of the Plan

The following description of the Bizco Corporation (Corporation) Employee Health and Welfare Benefit Plan (Plan) provides only general information. Participants should refer to the Plan agreement for a more complete description of the Plan's provisions.

1. *General.* The Plan provides health and death benefits covering substantially all employees of the Corporation. It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).
2. *Benefits.* The Plan provides health benefits (hospital, surgical, major medical, and long-term disability) covering full-time employees of the Corporation with 1000 hours of service each year. The Plan also provides health benefits to certain active and retired employees if they have accumulated in the current year or prior years credit amounts (expressed in hours) in excess of hours required for current coverage. Accumulated eligibility credits equal to approximately one year's coverage may be carried forward, and any credits in excess of approximately one year's coverage are converted into specified amounts of paid-up death benefits.
3. *Contributions.* The Plan agreement provides that the Corporation make quarterly contributions to the Plan of a specified amount for each hour worked (approximately x cents per hour in 19X1) to provide benefits for employees. The employer's contribution rate is determined annually by the Plan's actuary. Beginning in 19X2, the Corporation's contribution is expected to increase approximately 7 percent (to y cents per hour) to provide for the increase in benefits attributable to the Plan amendment effective July 1, 19X1 (Note C). An employee may contribute specified amounts, determined annually by the Plan's actuary, to extend coverage to eligible dependents of the employee.

B. Summary of Accounting Policies

1. *Valuation of Investments.* If available, quoted market prices are used to value investments. The amounts shown in Note D for securities that have no quoted market price represent estimated fair value. Many factors are considered in arriving at fair value. In general, however, corporate bonds are valued based on yields currently available on comparable securities of issuers with similar credit ratings. Investments in certain restricted common stocks are valued at the quoted market price of the issuer's unrestricted common stock less an appropriate discount. If a quoted market price for unrestricted common stock of the issuer is not available, restricted common stocks are valued at a multiple of current earnings less an appropriate discount. The multiple chosen is consistent with multiples of similar companies based on current market prices.
2. *Plan Benefits.* Plan liabilities for health claims incurred but not reported, future benefits to retired participants and accumulated eligibility of participants as of December 31, 19X1, are estimated by the plan's actuary in accordance with accepted actuarial prin-

ciples. The liability for death benefits has been determined by the application of the unit risk rates computed in accordance with actuarial principles and discounted to present value assuming an average investment return rate of 7.5 percent.

C. Plan Amendment

Effective July 1, 19X1, the Plan was amended to increase major medical coverage from 60 to 75 percent of costs after $100 deductible. The Plan's actuary estimates that the amendment has resulted in an increase in health benefits payable under the Plan of $115,000 in 19X1, and that the amendment will result in an increase of 7 percent in the Corporation's contribution in 19X2.

D. Investments

The Plan's investments are held by a bank-administered trust fund. The following table presents the fair values of investments. Investments that represent 5 percent or more of total plan assets are separately identified.

Fair Value of Investments

	December 31, 19X1	
	Numbers of Shares or Principal Amount	**Fair Value**
Investments at Fair Value as Determined by Quoted Market Price		
U.S. government securities		$1,171,000
Corporate bonds and debentures		
Commonwealth Power 9% bonds due 19X4	$200,000	172,000
Other		74,000
Common stocks		
Bizco Corporation	2,000	30,500
Other		110,000
		1,557,500
Investments at Estimated Fair Value		
Corporate bonds	$150,000	114,000
Common stocks		78,500
		192,500
Total investments at fair value		$1,750,000

During 19X1, the Plan's investments (including investments bought, sold, and held during the year) appreciated in value by $12,000 as follows:

Net Appreciation (Depreciation) in Fair Value

	Year Ended December 31 19X1
Investments at Fair Value as Determined by Quoted Market Price	
U.S. government securities	($15,000)
Corporate bonds and debentures	(7,000)
Common stocks	31,000
	9,000
Investments at Estimated Fair Value	
Corporate bonds	(2,000)
Common stocks	5,000
	3,000
Net appreciation in fair value	$12,000

Vacation Benefit Plan

UAGW Vacation Benefit Plan
Statement of Net Assets

	December 31 19X2
Assets	
Investments, at fair value (Notes B and C)	
U.S. government securities	$ 850,000
Certificates of deposit	650,000
Total investments	1,500,000
Receivables	
Employers' contributions (Note A)	152,000
Accrued interest	9,000
	161,000
Cash	26,000
Total assets	1,687,000
Liabilities	
Accounts payable	17,000
Vacation benefits payable	
19X0 and prior plan years	25,000
19X1 plan year	31,000
19X2 plan year	1,600,000
Total vacation benefits payable	1,656,000
Total liabilities	1,673,000
Net assets	$ 14,000

The accompanying notes are an integral part of these financial statements.

UAGW Vacation Benefit Plan
Statement of Changes in Net Assets

	Year Ended December 31 19X2
Additions to net assets attributed to:	
Investment income	
Net appreciation in fair value of investments (Note C)	$ 6,000
Interest	113,000
Less investment expenses	(8,000)
	111,000
Employers' contributions	2,145,000
Total additions	2,256,000
Deductions from net assets attributed to:	
Payments for vacation benefits for—	
19X0 and earlier plan years	37,000
19X1 plan year	1,427,000
19X2 plan year	624,000
	2,088,000
Net additions to total liability for vacation benefits	103,000
Administrative expenses	85,000
Total deductions	2,276,000
Net decrease	(20,000)
Net assets	
Beginning of year	34,000
End of year	$14,000

The accompanying notes are an integral part of these financial statements.

UAGW Vacation Benefit Plan
Notes to Financial Statements

A. Description of the Plan

The following description of the UAGW Vacation Benefit Plan (Plan) provides only general information. Participants should refer to the Plan agreement for a more complete description of the Plan's provisions.

1. *General.* The Plan was formed under an agreement between the Contractors' Association and the UAGW labor union (Union). The Plan covers all members of the Union employed under the terms of the collective bargaining agreement with the members of the Contractors' Association.

2. *Contributions and Benefits.* Employers contribute to the Plan x cents for each hour worked by Plan participants. The amount accumulated in each participant's vacation account as of September 30 of each year is paid on or after December 1 to the participant unless the participant elects to hold the amount in the vacation account. Benefits unclaimed after seven years revert to the Plan.
3. *Investment Income.* Investment income in the Plan is used primarily to pay the Plan's administrative expenses. Excess of investment income over administrative expenses may be carried forward to later years or distributed to participants on a pro rata basis at the discretion of the trustees.

B. Summary of Accounting Policies

1. *Valuation of Investments.* Investments are valued at fair value as of December 31, 19X2. If available, quoted market prices are used to value investments. Such investments are valued at the mean of bid and asked prices as obtained from one or more market makers in those securities. The amounts shown in Note C for investments that have no quoted market price represent estimated fair value, which is determined based on yields equivalent for such securities or for securities of comparable maturity, quality, and type as obtained from market makers. Gains and losses on investments that were both bought and sold during the year are included in net appreciation in fair value.
2. *Contributions.* Employers' contributions receivable represents amounts due as of December 31, 19X2, under terms of the collective bargaining agreement. The amount shown is net of $3,000 estimated to be uncollectible.

C. Investments

The Plan's investments consist of U.S. Treasury bills, other obligations issued or guaranteed by the U.S. government or its agencies, and bank certificates of deposit. The Plan's investments are held by a bank-administered trust. The following table presents the fair value of investments. Investments that represent 5 percent or more of total plan assets are separately identified.

Fair Value of Investments

	December 31, 19X2	
	Principal Amount	Fair Value
Investments at Fair Value as Determined by Quoted Market Price		
U.S. government securities		
U.S. Treasury notes, 8.1%, Feb. 15, 19X3	$250,000	$ 248,000
Other various	617,000	602,000
		850,000
Investments at Estimated Fair Value		
Negotiable bank certificates of deposit		
Bakers Trust, 8.4%, Jan. 22, 19X3	200,000	200,000
Mechanical Bank, 9.8%, Feb. 14, 19X3	200,000	201,000
Zitibank, N.A., 10.2%, March 1, 19X3	200,000	201,000
Other various	48,000	48,000
		650,000
Total investments at fair value		$1,500,000

During 19X2 the Plan's investments (including investments bought, sold, and held during the year) appreciated in value by $6,000 as follows:

Net Appreciation (Depreciation) in Fair Value

	Year Ended December 31 19X2
Investments at Fair Value as Determined by Quoted Market Prices	
U.S. government securities	$8,000
Investments at Estimated Fair Value	
Negotiable bank certificates of deposit	(2,000)
Net appreciation in fair value	$6,000

Topical Index

[References are to paragraph numbers]